EXECUTIVE COMPENSATION IN U. S. BUSINESS FIRMS

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INTRODUCTION

BACKGROUND

The business firm in the United States has recently found itself faced with a major shift in the forces which operate to determine the usefulness of a particular executive compensation plan. A plan is considered to cease to be useful when it does not optimize its contribution to three basic purposes.[1] The basic purposes of such a plan are the satisfaction of the financial needs of executives, the motivation of executives toward more successful achievement of company objectives, and the inducement it offers in the recruitment of executive talent.

The nature of the current dilemma in maintaining an effective executive compensation plan was described in Business Week as one in which "a new (tax) reform bill, a bear market on Wall Street and galloping inflation have thrown corporations into a turmoil over how to pay their top executives--particularly those who reap $75,000 to $100,000 a year."[2]

These changes have shifted the foundations upon which many approaches to executive compensation have been built. Therefore,

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[1]Peter F. Drucker, The Practice of Management (New York: Harper and Row, 1943), p. 63.

[2]"A Confusing Payday for Men at the Top," Business Week, (October 10, 1970), p. 80.

it was considered timely to undertake a review of the executive compensation problem with the aim of identifying viable alternatives which are available to the firm. Rudimentary to this review is the establishment of a frame of reference with regard to the major considerations around which an executive compensation plan is developed.

RESEARCH QUESTION

The primary research question explored in this study is: What are the major considerations in developing a viable executive compensation plan for a business firm?

In order to properly respond to this question, it is necessary to consider the following subsidiary questions:

1. What are the major elements of an executive compensation plan?

2. What are the factors external to the firm which impact on an executive compensation plan?

3. What compensatory options are open to the firm?

4. What are the motivational aspects of executive compensation?

5. What are some significant innovative trends in executive compensation?

SCOPE OF THE STUDY

The study is approached from the point of view that the executive compensation dilemma facing industry today is sufficiently revolutionary in implication that a comprehensive review of the foundations of such a plan is in order. Therefore, the scope of the study will include an analysis of the major elements of an executive compensation plan. The focus of this analysis will be organized in terms of base salary, bonuses, and deferred compensation.

Preliminary research has indicated that base salary, and to a lesser degree deferred compensation, intended to serve the security needs of the individual executive, offers fewer opportunities for innovative approaches to compensation than do bonuses and other devices which relate to fostering the entrepreneurial spirit. Therefore, emphasis will be placed upon identifying the options available to the firm in this latter area. The study will attempt to look at each major option in terms of its basic nature, its advantages, and disadvantages from the viewpoints of both the firm and the individual and the circumstances which foster its use.

Current literature on the subject of executive compensation is replete with suggestions for more effective management of compensation programs, approaches for greater personalization of programs to meet individual executive needs and predictions concerning the form executive compensation will take in the 1970's. Several noteworthy proposals will be presented in summary form.

RESEARCH METHODOLOGY

Research for the study consists primarily of secondary sources. The theoretical approach is considered superior for the purposes of this study since the emphasis is on what ought to be, not on what is being employed to provide suitable executive compensation.

ORGANIZATION OF THE STUDY

The study is structured to incrementally develop a frame of reference which could serve as the basis for formulating an executive compensation plan for any publically held business firm. Each of the major areas of consideration is related to the overall environment and selective factors of major consequence in each of these areas is explored in greater depth.

Chapter II identifies the elements of an executive compensation plan and provides an understanding as to how these elements relate in providing the structure of a comprehensive plan. Chapter III explores the major influences from outside the firm which can have a significant impact on a plan. Chapter IV is an in depth study of the various forms of stock options; the historical means of building an entrepreneurial incentive into executive compensation. Chapter V explores the motivational considerations of both stockholders and top executives. Chapter VI provides an exposure of some current innovative trends in executive compensation. Chapter VII contains a summary and conclusions from the data presented in the preceding chapters.

CHAPTER II

MAJOR ELEMENTS OF AN EXECUTIVE COMPENSATION PLAN

The focus in studying the elements of an executive compensation plan will be from the point of view of the top two or three executives in a business firm. Executives at these levels in a corporate structure are in a position in which they bear responsibility for success or failure of the enterprise. In addition, they are usually individuals who have proven themselves to be of exceptional caliber and represent an asset upon which the fortunes of the business are dependent. Therefore, it can be appreciated that the executive compensation structure has to be designed to attract men competent to accomplish company objectives and motivate them to seek greater responsibility in the company.[1]

A comprehensive executive compensation plan for these top caliber executives and their understudies can be seen to require the granting of a competitive basic salary and a means to provide a reward for achieving success in the management of the corporation. A third requisite of a plan is to provide a means by which an executive can hope to eventually retire and have a sufficient income to offer him the opportunity to enjoy the pleasures he had to forego during his active pursuit of corporate success. Thus,

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[1]Arch Patton, Men, Money and Motivation (New York: McGraw-Hill Book Co., Inc., 1961), p. 67.

executive compensation is a three part package. The amount of base salary has been identified as reflecting a man's value in the market place. It has been said that the measure of a man's esteem in the eyes of his associates remains his salary.[1] Supplemental compensation in the form of bonus and profit sharing plans, incentive compensation, and other similar devices provide motivation for the executive to maximize his contribution to the firm. The third general category of compensation needs fall under the heading of protective compensation. This includes pension and other retirement plans, insurance, and deferred compensation.[2]

The remainder of this chapter will be spent in investigating each of these three elements of executive compensation.

BASE SALARY

The term base salary rather than salary is used intentionally to connotate that fixed portion of an executive's compensation with the inference that there is an opportunity provided for additional compensation in some other form.

Most companies have base salary schedules. These provide not only a reflection of the expected pay one would receive as he advances up the hierarchial ladder in the firm, but also says something about the nature of the authority and responsibility structure within the firm.

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[1]"What's a Good Man Worth?" Business Week, (June 1, 1968), p. 58.

[2]William D. Trader, "Guideposts to Executive Compensation Planning," in Compensating Executive Worth, ed. by Russell F. Moore (New York: American Management Association, 1968), pp. 13-14.

Two typical salary arrangements, representing both ends of the normal salary schedule spectrum are illustrated below.

TABLE 1

SALARY SCHEDULE CONTRAST

POSITION IN FIRM	ARRANGEMENT 1 STEEP PYRAMID SALARY	ARRANGEMENT 1 STEEP PYRAMID PERCENT OF PRESIDENT'S SALARY	ARRANGEMENT 2 FLAT PYRAMID SALARY	ARRANGEMENT 2 FLAT PYRAMID PERCENT OF PRESIDENT'S SALARY
President	100,000	100	100,000	100
Sales Vice President	25,000	25	95,000	95
Manufacturing Vice President	23,000	23	85,000	85
Treasurer	20,000	20	75,000	75
Chief Engineer	15,000	15	60,000	60

SOURCE: This table was constructed by the author based upon data presented by Arch Patton in <u>Men, Money and Motivation</u>, pages 70-72.

The steep pyramid is more representative of the organization established and run with an iron hand by an entrepreneur. The flat pyramid too often characterizes companies which are run by a form of committee management. The big difference is that more than anything else the shape of the salary schedule reflects the difference in demands on individuals in the respective firms. There are other generalizations about the two extreme salary schedule arrangements which have been observed as a result of analyzing executive compensation surveys in American industry.

The following table has been developed to illustrate general characteristics identifiable to the spectrum of salary schedules between the steep and flat pyramid extremes. The total compensation for individuals in the steep pyramid arrangement is more typically dependent upon sizable bonuses added to base salary as a reward for successful performance.

TABLE 2

SUMMARY OF SALARY PYRAMID CHARACTERISTICS

	CHARACTERISTICS OF STEEP SCHEDULE INDUSTRIES	CHARACTERISTICS OF FLAT SCHEDULE INDUSTRIES
Volitile Nature of Industry	High Growth/Decline	Stable Growth
Competitiveness of Industry	Highly	Low to Moderate
Highly Creative Employees	Attracted	Not attracted
Threat of Failure upon Promotion	High	Low
Decision Making Process	Centralized	Decentralized
Normal Source of Executive Talent	External	Internal
Profit Growth of Company	Above Average	Average or Below
Representative Industries	Retail Trades	Banks

Salary schedules within a particular company are not truly arbitrary determinations. A company has to compete in the market

place for talent to fill all jobs from the production worker level to the top executive positions. Therefore, the base of a company's salary pyramid is dependent upon the wage it has to pay for its production and office workers. These rates are most often established by unions which have an impact within an entire industry. The first level of salaried workers above the union members are paid at a level slightly above the union rates.[1] Within the various levels of a company heirarchy of salaried workers, it is customary to find a differential in pay provided for increasing levels of responsibility. This differential not only provides a basic financial motivation to encourage individuals to aspire for increased renumeration. It also has significant status implications.

There is much difference of opinion on compensation regarding the choice of 5%, 10%, 15%, etc., differentials as arbitrary spreads between the various salaried levels.[2] These differentials are not truly arbitrary but in reality appear to be significantly determined by the competitive climate within an industry for certain types of talents such as financial specialists, marketing analysts, and engineers. These people, when placed in positions, serve as key determinants of salary spreads within levels of the salary schedule. If a company is required to pay a middle management level financial analyst $25,000, others in a similar

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[1]Patton, Men, Money and Motivation, p. 74.

[2]Ibid., p. 104, and Richard H. Allaway, Jr., "Developing the Basis for Executive Compensation," Compensating Executive Worth, ed. by Russell F. Moore (New York: American Management Association, Inc., 1968), p. 40.

hierarchical level will also be paid in that range.

The salary of the chief executive tends to place the lid on the top of the schedule.[1] This effect can be illustrated through considering a public utility firm. There is a natural inclination to avoid paying a public utility executive an astronomical salary since to do so would be to engender the wrath of the citizenry. However, such a firm is in competition for top level talent for management positions below the chief executive. Therefore, it can be expected that there will be a considerable compression of salary differentials in such an industry resulting in a flat pyramid structure near the top.

Salaries of individuals rarely decrease; therefore, there is a natural tendency for companies to be conservative in setting salary schedules. To do otherwise would tend to burden the company with a fixed cost which could be severely detrimental in periods of recession or general declining sales.[2] Companies tend to be unwilling to use base salaries as a means of adjusting an individual's compensation up or down in relation to his performance or that of his company for two basic reasons. It is felt that an executive should have the right to expect stability in that part of his compensation upon which he is dependent for meeting his personal financial affairs and standard of living. In addition, salary has come to be regarded in the business community as a relatively stable element. Consequently, a cut in

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[1] Ibid. pp. 38-39.

[2] Graef S. Crystal, "What's Ahead in Executive Compensation?" in Compensating Executive Worth, ed. by Russell F. Moore (New York: American Management Association, 1968), pp. 16-19.

salary carries with it the connotation that the person involved has been all but fired.[1]

Base salary, as a current cash payment for services rendered, becomes a less attractive financial reward for the highly paid top executives because it is subject to the "progressive income tax." There have been recent changes in personal income tax rates which will be discussed in some detail later in the paper. However, for the purposes of a more complete treatment of salary the following should be noted. In the early 1960's, an executive receiving a raise in base salary from $100,000 to $110,000 would find the raise of $10,000 subject to a 91% tax, assuming other aspects of his financial structure were not operative. The maximum rate was later lowered to 70%. As a result of the 1969 tax reform bill, the maximum tax will become 50% in 1972 coupled with a number of conditional provisions. From this brief discussion, it can be seen that the role of salary is to a great degree dependent on tax considerations in the higher earnings brackets. Executives are obviously concerned with maximizing the after tax income. The role of salary in the compensation mix cannot be considered independent of its comparative advantages over other alternatives.

Before leaving the subject of base salary, it must be pointed out that the level of base salary has tended to play an important role in the other facets of the total executive compensation package. It is common for bonus payments and retirement pay to be expressed as percentages of base pay or

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[1] Ibid., p. 17.

salary. Therefore, while it certainly can be a disadvantage on a short term basis to have a high base salary subject to high tax rates, this can be offset by the positive effect base salary has on determining the dollar amount of bonus and retirement benefits.[1]

SUPPLEMENTAL COMPENSATION

Supplemental compensation is regarded as any form of compensation which attempts to link the individual executive's personal interests with the interests of the corporate shareholders. The goal is to develop the executive compensation plan which will enable shareholders to reap greater dividends and provide executives with an opportunity to enjoy the greater financial rewards and recognition through efforts in pursuit of company goals.[2] Supplemental compensation can take a number of forms such as bonuses, profit sharing plans, incentive compensation or stock option plans.

When contrasted with base salary, it becomes apparent that the purpose of supplemental compensation is to provide a means of measuring and rewarding the short term contribution of the individual while salaries tend to reflect the long term value of the position occupied by the individual.[3] The supplemental compensation alternatives of profit sharing, bonus payments and stock options tend to be of varying importance to the top

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[1]Patton, Men, Money and Motivation, p. 86.

[2]Trader, "Guideposts to Executive Compensation Planning," p. 12.

[3]Patton, Men, Money and Motivation, p. 88.

executive. An illustration of how each of these compensation devices are used by Texas Instruments Incorporated provides a basis for understanding their nature and role.[1]

Texas Instruments started a profit sharing plan in 1942 and broadened it in 1951. The goal which led to establishing its plan was to cause employees at all levels to identify with the corporate objective of maximizing the long term profitability of the firm. After each year of operation, a percentage of company profits are placed in a trust fund. These profits are distributed among employees on the basis of a specified percentage of each dollar of base pay earned during the year in which profits were generated. Individual's proceeds from profit sharing are accumulated in the trust fund where interest is earned from investments of this money. After four years an individual is entitled to draw out his funds with interest payments. This feature is intended to encourage employees to remain on the payroll. Employees can choose to have their money invested in company stock rather than leaving it in cash in the trust.

This method of compensation does provide an accrual to the top executive as well as all company employees. However, its primary orientation is much broader than purely executive compensation. Exposure of this author to a similar use of profit sharing by General Electric Company tends to confirm this broad compensatory role for which profit sharing has been used in American industry.

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[1] P. E. Haggerty, "Incentives and Their Roles in the Development of Texas Instruments Incorporated" in Incentives for Executives, ed. by David W. Ewing and Dan H. Fenn, Jr. (New York: McGraw-Hill Book Co., Inc., 1962), pp. 141-164.

Bonus plans in theory represent an attempt by industry to provide a means of singling out exceptional performance with one time financial rewards. Texas Instruments is said to use them as a means "to reach, in a particular and individual way those men who have been especially responsible for the major successes of Texas Instruments and to furnish additional incentive for their continued success."[1] At Texas Instruments, bonuses typically are paid to key management people as well as scientists and engineers.

Bonus payments as incentives are often spoken of in less then favorable terms in much of the literature. It appears that a key to an effective bonus system is the establishment of objective criteria for the selection of appropriate candidates for recognition. The tendency over a period of time has been for at least minimal bonuses being paid to almost everyone in the top executive group.[2] Graef Crystal has pointed out that because of the above phenomena, bonus payments to worthy recipients have become lesser percentages of base salary thereby losing much of their theoretical motivating potential.

A difficulty in allocating bonuses has been the lack of ofjective measures of performance. Management by objectives as espoused by such respected management writers as Peter Drucker and George Odiorne has been adopted in principal by some corporations. One benefit which might be expected from such an approach is the establishment of a performance measure, accepted and understood within a company, which could revitalize the adminis-

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[1] Ibid., p. 155.

[2] Crystal, "What's Ahead in Executive Compensation?" p. 20.

tration of bonus plans.

The stock option is basically an entrepreneurial incentive and as such is the strongest motivator for prodding the profit making instincts of top executives.[1] Texas Instruments uses stock options as an incentive for future individual performance and never as a reward for past accomplishments. It is felt that in exercising his options, an executive makes a strong personal commitment to the firm.[2] For a number of years the extensive use of stock options as a compensatory device has been most heavily favored among top executives. One major contributing factor for this phenomena is that stock options have provided a means of avoiding the loss in income from the high personal income tax brackets these individuals found themselves in due to their sizable salaries.

Stock options by themselves do not cause miracles in the establishment of an executive's estate or in causing the executive to be successful in achieving significant profit and corporate growth. Arch Patton feels that for stock options to be effective four basic ingredients must be present.[3] The industry in which the company exists must be one in which aggressive action by management can result in a substantial impact on the company's growth. The executive must be in a position in the company in which he has sufficient opportunity to influence company growth. The individual given stock options must be in a financial position

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[1]Patton, Men, Money and Motivation, p. 231.

[2]Haggerty, "Incentives and their Role in the Development of Texas Instruments Incorporated," pp. 156-157.

[3]*Ibid.*, 195-196.

such that he realizes a tax advantage from stock options as opposed to some form of cash compensation. Patton's fourth ingredient is that the individual should be given options of sufficient value to serve as a substantial motivator.

The variety of ways in which stock options can be provided is considerable. It seems that the proliferation of forms in which stock options are offered has grown in response to shifting tax structures. These variations and the more technical aspects of stock options will be illustrated in greater detail in a later part of this paper.

There are two aspects of stock options which have to be recognized in even such a non-technical discussion as has been presented. Stock options basically permit an individual to purchase a specified number of shares of company stock at a bargain price. However, in order to take advantage of this option, he has to either have or obtain funds to meet the purchase price. If the funds have to be borrowed, the individual will have to pay interest on the money. This can significantly reduce or absorb the potential personal profit from the transaction.

Another factor which is operative is that stock options not only have specified time frames in which they must be exercised but also these options usually lapse if they have not been exercised prior to the departure of an executive for other employment.

One area in which stock options have been particularly effective is in their ability to attract particularly well

qualified executive talent to small corporations with very high growth potential. Arch Patton has stated that the executive staffing of the small high growth corporations in the 1950's and early 1960's achieved by offering stock options as a reward for the entrepreneurial risk of company building would not have been otherwise possible.[1]

PROTECTIVE COMPENSATION

The third part of the overall executive compensation package is designed to provide for the future needs of the individual as well as protect present payments from excessive tax erosion. In the area of providing for future needs fall such compensatory devices as insurance and pension programs. Deferral of compensation provides not only a means of putting off the receipt of monies until the executive's tax bracket may be lower but also tends to provide a sense of security in that the timing and amount of payments in future years can be depended upon.[2] The deferral of compensation does not simply imply a steady income, above pensions after retirement; normally an executive will begin to receive a steady stream of previously deferred payments during his later years of employment with a company. This makes the individual's take home pay less subject to the cyclical swings in in business activity which directly impact bonus payments and provides a flow of funds from which stock options can be exercised.

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[1]Arch Patton, "Are Stock Options Dead?" Harvard Business Review, XLVIII (September-October, 1970), p. 21.

[2]Trader, "Guideposts to Executive Compensation Planning," p. 14.

This aspect of the executive compensation package does not by nature represent a dynamic area of study. The deferral of compensation is a most significant aspect of a compensation program but it rises to importance as a result of other aspects of the total compensation package not as a causitive force in and of itself. Therefore, it is usually given consideration as an option to be selected by an executive who is receiving a particular financial reward he has earned through on the job performance. The selection of the particular form in which deferred compensation will be taken is an individual matter dependent on such factors as age, income, family status, and personal worth.[1]

Insurance programs normally include at least a simple term insurance policy. The variations of life insurance policies are limited only by the imagination of insurance company sales personnel and the willingness of corporations to pay the bills. A corporation can provide up to $50,000 of life insurance for each employee through payment of premiums and deduct the premiums on its income tax returns. This is a relatively low cost benefit which can be offered by a corporation resulting in a significant savings to employees.[2] An insurance program also has traditionally included a program for basic medical coverage, hospitalization and surgery under a group plan such as Blue Cross and Blue Shield in which both the employer and employee share premium

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[1]John P. Hyde, "The Total Management-Compensation Package," in Compensating Executive Worth ed. by Russell F. Moore (New York: American Management Association, Inc., 1968), p. 255.

[2]Frederick C. Kurtz, Associate Professor, The George Washington University, School of Business Administration, Lecture given at The George Washington University, August 27, 1971.

payment responsibility.[1]

Pension plans are basically programs under which an employee who retires from a firm is given a specified amount of money based on his salary during a specified period during his active employ for a company. Such a plan in which the employee also contributes a portion of his pay or a portion of deferred compensation is generally more broadly termed a retirement plan. Both of these means of providing a source of retirement income are characteristically encumbered with rules which stress the necessity for the employee's continuing in the company's employ to become eligible for payment. There is a recent trend toward payment of a termination benefit from the retirement fund to employees who leave a company prior to their eligibility for retirement.[2]

Insurance and pension provisions are not considered as particularly significant to the subject of this report but the limited discussion of their existance serves to provide a broader dimension to the executive compensation spectrum.

In this section of the thesis, emphasis has been on identifying the basic elements of an executive compensation program. At this point it is important to note the significant role that Tax considerations play in determining the form of compensation most favorable to both the executive and the firm. It will be from this frame of reference that more detailed analysis will be presented.

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[1]Hyde, "The Total Management-Compensation Package," pp. 252-253.

[2]*Ibid*.

CHAPTER III

EXTERNAL INFLUENCES ON AN EXECUTIVE COMPENSATION PLAN

It has often been said that "no man is an island." This time worn cliche can also be applied to a company in formulating an executive compensation plan. In developing a plan to incent its top level executives, a company cannot hope to maximize the contribution it will make to both the individual executive and the stockholder unless it succeeds in giving due consideration to major externally imposed rules under which it must operate.

The corporation is in effect a separate entity in the American economy and as such is subject to the controls and limitations imposed by government. Tax laws are one area which is particularly significant in evaluating the cost-benefit comparisons among compensatory options. In addition, the compensation environment of 1971-1972 is subject to the limitations of the Pay Board rulings made under Phase II of President Nixon's economic recovery program. A third significant external factor which has an influence on a corporate executive compensation plan is recognition of the possibility that the Internal Revenue Service may disallow part of the deduction for compensation on the basis that it is unreasonable. While these are not the only

external factors which a corporation has to consider, they are considered the three which today are imposing the greatest constraint on the formulation of an executive compensation plan.

In this chapter each of the three areas will be discussed in detail in order to provide a factual base for further discussion of compensatory options.

TAX STRUCTURE CHANGES

In the 1950's and early 1960's the top personal tax rate was as high as 91% while the capital gains tax was 25%. This situation obviously encouraged executives to seek compensation in a form in which the more favorable 25% rate could be paid.[1]

In 1964 Congress made revisions to tax laws to provide an incentive which would encourage the economy to grow more repidly. Among the provisions of these tax law changes was a reduction in the maximum tax rate on personal income from 91% to 70%. A corollary impact of this change was that the differential between personal income tax rates and capital gains rates was narrowed from 66% to 45%. Other provisions were that stock options had to be exercised within five years rather than ten and the executive was now required to hang onto stocks obtained by option for a minimum of three years to get capital gains treatment as compared to the previous six month holding period.[2]

The Tax Reform Act of 1969 was trumpeted by Congressmen as a measure which would eliminate the tax shelters by which over 225

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[1]"Top Men Demand New Kinds of Pay," Business Week, January 23, 1971, p. 65.

[2]Ibid.

Americans earning over $200,000 in 1968 paid no tax.[1] In 1970, 112 persons with incomes above $200,000 paid no federal income taxes.[2] Representative Henry S. Reuss (D-Wis.) in commenting on the 1970 situation reaffirms the primary objective of the Tax Reform Act of 1969 when he said, "The Tax Reform Act of 1969 was supposed to end this grand-scale tax avoidance, but it is obvious now that it has not done so."[3] This tax law was the one which has caused a proliferation of articles on the shift in executive compensation devices.

The impact of the Tax Reform Act of 1969 was no surprise to some astute corporate business executives. This is evidenced by the testimony of a number of individuals before the United States Senate Committee on Finance. Among those testifying was Leonard E. Kurst, Vice President and General Tax Counsel of Westinghouse Electric Company. He testified to the effect that deferred income, particularly in the form of capital stock was vital to the interests of American businesses since it provided a means of inducing top quality employees to remain with a company and it provided a real incentive for executives to give superior performances since they had a proprietory interest in their company.[4]

This testimony obviously did not have an effect since the

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[1]Arthur M. Louis, "Hidden Jokers in the New Tax Deck," Fortune, LXXXII, July 1970, p. 112.

[2]"Income Tax Drops; Loopholes Persist," The Washington Post, January 3, 1972, p. D9.

[3]Ibid.

[4]U. S. Congress, Senate, Committee on Finance, Tax Reform Act of 1969, Hearings before the Committee on Finance, Senate, 91st Cong., 1st sess., 1969, p. 1038.

provisions of the then proposed law which were objected to were included in the law as passed.

Initially the Tax Reform Act of 1969 was greeted with optimism by many of the ill-informed since it provided for a reduction in the maximum tax rate on earned income from the then current rate of 70 percent to 60 percent in 1971 and 50 percent in 1972. Earned income was a new term in the tax bill and was defined to include salaries, bonuses, and other compensation paid currently but excluded dividends, capital gains and such deferred compensation as pensions and profit sharing.[1]

The earned-income provision lowering personal tax rates was offset in the tax bill by a provision which singled out eight types of income that had previously been either tax free or subject to some form of favored treatment and imposed on them a 10 percent penalty tax. Two of these tax-preference items which will have a significant effect on the highly compensated top executives are: the difference between the exercise price and the market price of qualified stock, at the time it is purchased, will be treated as regular income and one-half of any net long-term capital gains will be subject to a 10 percent penalty tax.[2]

Under the 1969 tax law, capital gains taxes increase from a maximum of 25 percent of total net gain to 29-1/2 percent in 1970, 32-1/2 percent in 1971, and 35 percent in 1972.[3]

The following figure has been constructed to illustrate

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[1]Louis, "Hidden Jokers in the New Tax Deck," p. 100.

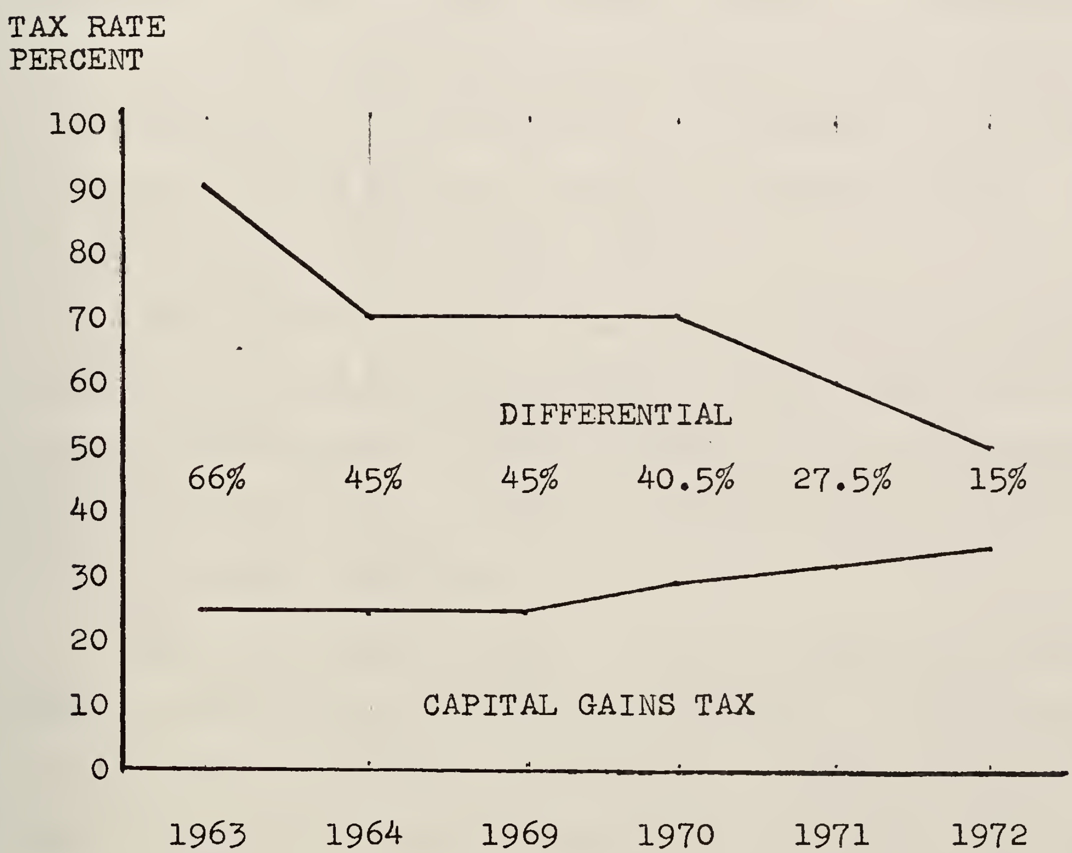
[2]*Ibid.*, p. 101-102.

[3]*Ibid.*

the trend in the tax structure relationships between personal income taxes and capital gains taxes. The figure is based on the data previously presented.

FIGURE 1

INCOME AND CAPITAL GAINS TAX RATE CHANGES



SOURCE: Constructed from data presented by Arthur M. Louis in "Hidden Jokers in the New Tax Deck," pp. 100-102, 112.

From this figure it is obvious that the advantages of finding a means for compensating an executive in a way which will provide application of the capital gains tax rates are rapidly diminishing. When the penalty tax provisions are taken into consideration,

it is possible that many executives in higher brackets will find the risks of stock options greater than the present value of potential gains.

An illustration of the effect of the tax laws in dollars and cents comparing the tax in 1969 and again in 1972 on a hypothetical executive is in order.[1] Assume the executive in question has $150,000 of taxable earned income and other income consisting of $300,000 in net long-term capital gains in both years. Under the old law he would have been taxed $76,980 on the earned income and 25% of the $300,000 or $75,000 on capital gains. His total tax bill would have been $151,980.

Under the new law the computation is much more complicated and will be illustrated in Table 3. Thus, under the new law the hypothetical executive would pay $181,974 in 1972 compared with $151,980 in 1969 or an increase of $29,994 in taxes under the new law on the same earnings.

Under the 1969 tax law an executive also was caused to lose some tax deductions on investment interest if this was in excess of a minimum sum of $25,000 on joint returns. If an executive was borrowing in excess of $250,000 at 10% ($25,000 interest), only one-half of the amount of interest above $25,000 could be used as a tax deduction under certain conditions. The entire deduction can be taken as an offset to dividends if the dividends are more than or equal to the interest in excess of $25,000.[2]

The major impact on pensions and profit-sharing income is that starting in 1970, any contributions made by employers to

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[1] _Ibid._

[2] _Ibid._, p. 111.

TABLE 3

ILLUSTRATIVE TAX COMPUTATION - 1972

NOTES	INCOME CATAGORY	DOLLARS TAXABLE	TAX	TOTAL TAX
	Earned Income ($150,000)			
	First	52,000	18,060	
	Remaining @50%	98,000	49,000	67,060
1	Capital Gains as a Tax Preference Item			
	Tax Preference of 1/2 of $300,000	150,000		
	Minus-allowed exclusion	30,000		
	Taxable under preference provision	120,000	9,920	9,920
	Penalty Tax on Income			
	Income	150,000		
	Minus exclusions (30,000 + 67,060)	97,060		
	Income subject to 10% penalty	52,940	5,294	5,294
	Net Tax on earned Income			82,274
	Tax on Capital Gains			
	25% on first	50,000	12,500	
2	Up to 35% on remaining	250,000	87,200	99,700
			TOTAL TAX	181,974

NOTES 1. If capital gains income exists, one-half of such income is treated as a tax preference item bringing tax on income up to the tax level under the pre-1969 law of 76,980.

2. Tax applied at various escalating rates up to 35%.

SOURCE: Constructed from data provided by Louis, "Hidden Jokers in the New Tax Deck," p. 102.

these plans will be taxed as ordinary income in the year the payment is actually received rather than as previously at capital gains rates. Any appreciation in value of funds held in trust will continue to be taxed at the capital gains rates. This seems to be an attempt to discourage the deferral of income. If the executive's income is less in the later years, placing him in a lower tax bracket, he can still realize some advantage from deferral of income.[1]

The tax structure is likely to become even more bleak in the future. In an attempt to prevent a few highly paid individuals from avoiding taxes, more stringent tax provisions are likely to be written into law. Representative Henry S. Reuss (D-Wis.), senior member of the House Banking Committee, and Representative James Corman (D-Calif.) are co-sponsoring a tax reform bill which they will introduce in Congress in early 1972.[2] This bill is designed to plug more "loopholes."

The tax provisions previously discussed are almost entirely effective on the income of executives. The corporation tax structure as it relates to the compensation of executives has not changed under the recent tax law changes. For analytic purposes the corporation tax is at a constant marginal rate on income. The tax rate is 22 percent on all income up to $25,000 and 48 percent on all income over $25,000.[3] The effective differences in cost-benefits to the firm in comparing alternative means of

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[1]Ibid., p. 112.

[2]"Income Tax Drops, Loopholes Persist," The Washington Post, January 3, 1972, Sec. D, p. 9.

[3]Eugene F. Brigham and Fred J. Weston, Managerial Finance (3rd ed., New York: Holt, Rinehart and Winston, 1969), p. 37.

compensation lie in the fact that some options provide the firm with tax deductions while others do not. These differences will be pointed out when specific options are discussed in detail.

PHASE II - EXECUTIVE COMPENSATION CONTROLS

On August 15, 1971, President Nixon announced his far reaching program to bring about economic recovery in the United States. His initial action placed a 90 day freeze on wages and prices. The longer term effect of this program which is to impact on executive compensation programs is beginning to be understood under guidelines for executive compensation laid down by the Pay Board on 17 December 1971. A summary of the more significant provisions of the Pay Board's ruling on executive compensation follows:

> The salaries and other compensations of executives cannot exceed 5.5 percent of their value during the established base period.
>
> The base period from which a company can compute the 5.5 percent increase is any one of the last three fiscal years of the company ending before November 14, 1971.
>
> An employer with a formal compensation plan in effect cannot exceed the amount of incentive compensation paid and bonuses payable or number of units of stock available for options by more than 5.5% of that of the base period.
>
> An employer cannot adopt a new plan or revise an existing executive compensation plan, program, or practice without the approval of the Pay Board.
>
> An employer wishing to obtain an exception from the basic provisions of the policy must provide evidence that the plan is an incentive program related to a productivity increase.[1]

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[1]"Boards Text on Executive Compensation," The Wall Street Journal, December 28, 1971, p. 6.

It can be appreciated from the above summary that a significant question to be asked is, "What was the level of compensation for executives during the base period?"

A compensation survey released by McKinsey in August 1971 showed "that pay for chief executives in 577 of the largest U. S. corporations rose by only 0.6 percent last year (1970)"[1] However, this should not provide a significant restraint since a number of large companies such as General Motors paid their executives handsome bonuses in 1968 and 1969, the first two years under the three year base line rule.[2] The companies who are expected to be hurt are those companies such as International Telephone and Telegraph Corporation whose top executives get half or more of their pay in the form of bonuses, which have been growing at 15 to 30 percent a year over the past three years.[3] In these instances bonuses constitute the heart of their executive compensation plans. With these held to a 5.5 percent increase and no alternative precedent established for stock option plans which could offer offsetting growth potential their executives can expect to feel the squeeze.

The salary and benefits portion of executive compensation plans in most companies will feel no effect from the rulings. Consultant Robert Sibson, President of Sibson and Company said:

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[1]"Pay at the Top Feels the Freeze," Business Week, August 28, 1971, p. 39, parenthesis added for clarity.

[2]"Bonuses as Usual--But Not for All," Business Week, January 1, 1972, p. 19.

[3]Ibid.

> The problem that most companies face is that application of the maximum limits of the guidelines would result in pay increases greater than companies would otherwise grant their non-union employees.[1]

One implication of the stock option ruling which prohibits an increase in the number of shares above that in the base period is that the earlier grants of shares were made in a period of a bull market in which fewer shares than normal were granted due to their inflated price. With the current market depression an equivalent compensation will require the granting of a greater number of shares.

There seems to be a general feeling among Washington businessmen that the present stringent Phase II controls are a short lived phenomena.[2] This feeling is endorsed by Herbert Stein, Chairman of the President's Council of Economic Advisors who said he believed "we will get back to the prefreeze era of no controls" and that "we can live without controls and without inflation."[3] In the same reference Stein was said to have predicted that all but major firms might be exempt from controls by the end of 1972. If this latter comment becomes a reality, large corporations will certainly have to take into consideration the impact of the Pay Board guidelines on executive compensation at least through 1973.

UNREASONABLE COMPENSATION CLAIMS

One of the most common corporate tax problem areas is the

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[1] _Ibid._

[2] Most D. C. Businessmen Believe Controls Will End," _The Washington Post_, January 9, 1972, Sec. L, p. 17.

[3] _Ibid._

disallowance by the Internal Revenue Service of part of the deductions they claim for compensation. This is particularly true of top executive compensation.[1] This problem is expected to become more severe as time passes. Some of the reasons cited are that IRS agents with the aid of computers are able to compare executive compensation for comparable positions in companies of similar size within similar industries. Disgruntled employees appear to be more prone to talk with people outside the firm about closely held corporate information on compensation matters.[2] In addition, as previously referenced, there has been considerable attack from Congressional representatives on high salaries and tax avoidance techniques relative to top executive compensation.

As a result of this pressure a new procedure has evolved whereby an executive will reimburse a corporation for any portion of his salary which is disallowed as unreasonable by the Internal Revenue Service. He would then be entitled to a tax deduction in the year in which the repayment is made.[3] To comply with this new procedure a corporation has to have an obligation of this nature established in writing in either its by-laws or directors minutes.

The problem of an issue of unreasonable compensation arising in a closely held corporation is most likely to arise through the investigative efforts of the Internal Revenue Service. Publicly

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[1]Robert S. Holtzman, "How to Cope with 'Unreasonable Compensation' Claims," Harvard Business Review, XLIX (September-October 1971) p. 79.

[2]*Ibid*., p. 80.

[3]*Ibid*.

held companies are usually challenged on the reasonableness of compensation by small stockholders.[1]

The most successful defense against such claims in negotiation with the Internal Revenue Service, stockholders, and the courts has been the ability to illustrate in some manner that the compensation has been based on company profits.[2] Therefore, it can be expected that there is a strong tendency within American industry to develop an executive compensation plan which in theory, at least, is tied to company profits.

This unreasonable compensation issue can work for the employee as well as the employer. If in bargaining for a raise, an executive is advised that there is corporate fear of an unreasonable compensation disallowance he can remind his employer that, if his request is unreasonable, the Internal Revenue Service will disallow it and he will repay the excess compensation. The individual executive under these conditions is much more likely to be in a position and more motivated to justify his worth than would a corporation. In addition, stockholders would not be in a strong position to object to compensation not disallowed by the Internal Revenue Service.[3]

In this chapter it has been illustrated that the tax aspects of executive compensation are in fact becoming more complicated. The differential between taxes on ordinary income and capital

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[1]Walter S. Rothschild, "Legal Problems of Executive Compensation," in Compensating Executive Worth, ed. by Russell F. Moore (New York: American Management Association, 1968), pp. 186, 194.

[2]Ibid., p. 195.

[3]Holtzman, "How to Cope with Unreasonable Compensation Claims," p. 81.

gains is becoming significantly more narrow. There is today a much greater chance that corporations will have executive compensation tax deductions disallowed as unreasonable.

To this restrictive environment is added the controls established by the Pay Board under Phase II of President Nixon's economic recovery program. A significant implication of this program is that over the next two years, at least, a corporation which does not have an executive compensation plan which has been revised to properly consider the Tax Reform Act of 1969 or which has not been formalized will be required to show a relationship between incentives and increased productivity to obtain Pay Board approval.

The fact that an attractive executive compensation plan is hard to maintain in a tax environment was pointed out by Dale Yoder even before the current more restrictive tax laws were passed. In 1962 he pointed out that:

> Programs of executive compensation have not been successful in maintaining the historic differentials in executive pay. The structure has narrowed. Executive pay has not maintained its earlier ratio to profits. Progressive income taxes now cut deeply into executive salaries and limit opportunities for saving.[1]

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[1]Dale Yoder, Personnel Management and Industrial Relations (5th ed., Englewood Cliffs, N.J.: Prentice-Hall, Inc.), p. 487.

CHAPTER IV

STOCK OPTIONS

Stock options have been a central point of discussion in many of the recent articles on executive compensation. Much of the discussion has been caused by the impact that the Tax Reform Act of 1969 has had on this compensatory device. The recent proliferation of copy on the subject is also indicative of the very significant importance stock options have been given in top executive compensation programs. The high regard for stock options was pointed out by Arch Patton in the following quotation.

> Based on my experience with stock option administration in many client companies throughout the 1950's and 1960's, I am convinced that such options made a measurable contribution to the dramatic upswing in industrial production. The stock option not only equated executive and stock holder interest, but also provided the basis for making profit building an exciting and rewarding activity.[1]

In this chapter an indepth study of stock options is presented. The initial emphasis is given to developing an increased understanding of the various types of stock options which are being offered as executive compensation media. This includes an illustration of the relative mix in which the various options are now used, and an explanation of each type of option in terms of its basic distinguishing characteristics. The tax effects and commonly cited advantages and disadvantages of each

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[1]Arch Patton, "Are Stock Options Dead?" Harvard Business Review, XLVIII (September-October 1970), p. 21.

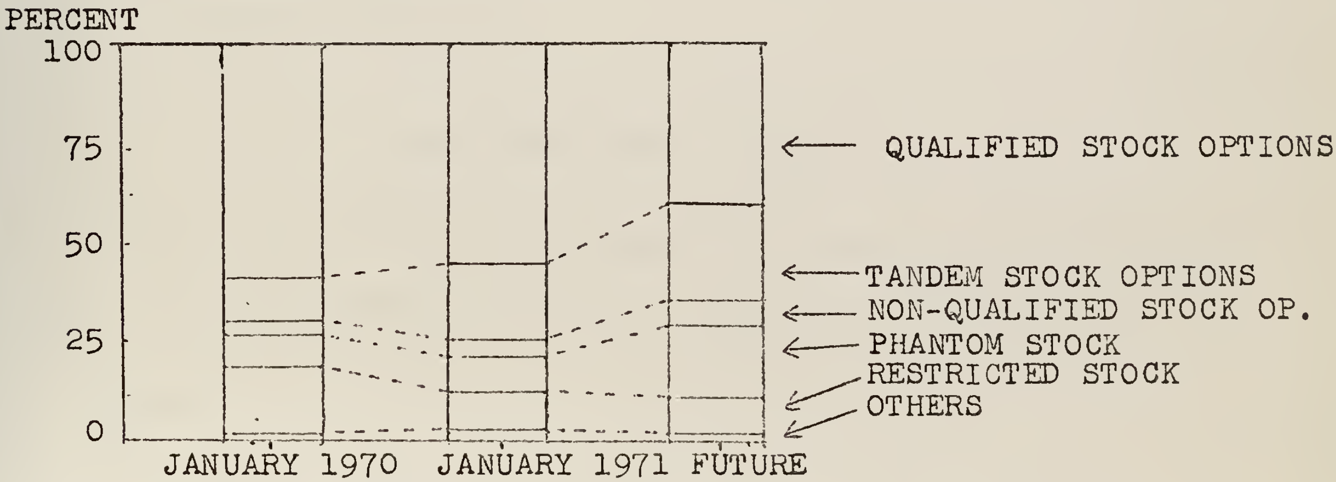
from the point of view of both the corporation and the individual executive are also presented. The final portion of the chapter highlights major considerations in the use of this compensatory device.

Stock options have been offered in five major types. These types are qualified stock options, non-qualified stock options, phantom stock, restricted stock, and tandem stock. One essential, although often subtle, difference is the affect of each on the tax liability of both the executive and the corporation. This tax effect has been a prime cause in the recently observed shift in the relative use of each of these forms of compensation.

Figure 2, developed by McKinsey and Company from a sampling of 165 large companies in a mix of industries illustrates this significant shift. It also shows the expected continuation of this shift over at least the next two years.

FIGURE 2

THE CHANGING MIX OF STOCK OPTIONS



SOURCE: "Top Men Demand New Kinds of Pay," Business Week, January 23, 1971, p. 65. This figure was prepared by McKinsey and Co. based on a survey conducted by David Kraus, Jr. and David J. McLaughlin.

In addition to the change in the mix, the overall use of stock options has shown some decline. The McKinsey study indicated that in two-thirds of the companies surveyed fewer executives are getting options and two-thirds of the companies also were reported as making smaller grants. However, most companies are said to want to use some form of option as a long term incentive.[1] This is confirmed by one of the findings of the Sixth Annual Management Compensation Study conducted by Sibson and Company, management compensation consultants. One of their principal findings was that stock option plans are not dead. They are simply being overhauled to make them more effective in the light of current stock market and tax conditions.[2]

There is a practical side to stock options which may also account for much of the effort being given to adjusting the mix of option types rather than retreating to salary and bonus alternatives. Robert D. Hulme points out that, "With the tremendous number of tender offers being made, it is always nice for the company that wants to continue its own identify to have stock in friendly hands."[3]

QUALIFIED STOCK OPTIONS

A qualified stock option plan is one which is developed in accordance with specific Internal Revenue Service guidelines in

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[1] Ibid.

[2] Robert E. Sibson, "Executive Pay--A Time of Dramatic Change," Nations Business, November, 1970, p. 89.

[3] "What's a Good Man Worth," Business Week, June 1, 1968, p. 57.

order that the recipient of the option can be eligible for taxation on financial gains at capital gains rates.[1] The specific conditions of the qualified stock option are:

> The plan must be approved by shareholders and the total number of shares reserved for options over the life of the plan must be specified.
>
> The plan must expire no later than ten years after it is first adopted.
>
> The option price per share must be at least equal to the fair market value of the stock as of the date any option is made.
>
> An individual option must be exercised within five years from its date of grant.
>
> The optionee must be an employee of the company and, after the grant has been made, may not own more than 5 percent of the total shares outstanding. (This rule has been somewhat liberalized for very small companies.)
>
> The optionee may not exercise an option so long as another qualified option granted on an earlier date and carrying a higher option price per share is currently outstanding.
>
> The optionee must hold an option for at least three years after its exercise in order to qualify for long term capital gains treatment on all appreciation which occurred between the date of the grant and the date of exercise.[2]

The total appreciation that may occur when an option is eventually sold is basically considered to consist of two parts. The first part is the difference between the option price and the market value on the date the option is exercised. This is referred to as the spread. The second part is the gain in market value which occurs between the time of exercise and the

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[1]Arthur M. Louis, "Hidden Jokers in the New Tax Deck," Fortune, LXXXII, July 1970, p. 112.

[2]Graef S. Crystal, Financial Motivation for Executives, New York: American Management Association, 1970, pp. 199-200.

time the stock is sold. The first part is the portion of appreciation which will be taxed as ordinary income unless the stock is held three years from exercise. The second part is eligible for capital gains treatment six months after the exercise period.[1]

In addition to the above required provisions of a qualified stock option plan, a company also can impose additional restrictions on such a plan. It is not uncommon for a company to restrict the percent of the grant an executive can exercise in one year.[2] The usual intent in such cases is to strengthen the chains which bind an executive to one company. This is particularly true when a company does not issue stock options each year.

The company is not permitted to claim a tax deduction for qualified stock options since the recipient is getting the preferential tax treatment. Assuming a marginal corporate tax rate of 48 percent, a corporation could issue the same number of shares of a type of stock option which is tax deductible for a net cost of 52 percent of the qualified stock.[3]

Contrary to much public opinion, a company does realize a cost when an individual is given a stock option. The cost is the discount the option holder gains through the stock's appreciation between the time of the grant and time the option is exercised. While this does not show up in the company income statement, it is an opportunity cost in that the stock could have

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[1] Ibid., p. 201.

[2] Ibid., p. 202.

[3] George W. Hettenhouse, "Cost/Benefit Analysis of Executive Compensation," Harvard Business Review, XLVIII (July-August 1970) p. 122.

been sold on the market on the day of exercise.[1] Shareholders also feel an additional cost of qualified stock option grants since earnings per share decline because of the increase in the total number of shares outstanding.

There is an advantage to the corporation of the stock option in terms of funds flow in that there is no loss in working capital.[2] The amount the executive pays the company to exercise his option is in fact a one time increase in working capital.

The exercise of a qualified stock option requiring the executive to hold the stock for three years for capital gains treatment can present serious problems of financing. With the reduced spread between capital gains treatment and earned income taxes the differential can easily be absorbed by the present high interest rates. The relationship between borrowing to exercise options and the income level of the individual concerned is also a significant factor. A middle management executive would likely find himself in a personal income tax bracket of about 30 percent. If he borrowed funds at 10 percent to exercise his option, he would be paying a net after tax interest rate of 7 percent since he could deduct 30 percent of his interest. A top executive in the maximum 50 percent bracket would pay only a net interest rate of 5 percent. This fact coupled with the fact that the middle management executive is paying a personal income tax rate close to what his capital gains tax rate would be brings home the fact

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[1]Graef S. Crystal, "The 10 Commandments of Executive Compensation," Financial Executive, August 1970, p. 53.

[2]Richard E. Wettling, "An Up-to-Date Look at Stock Options and their Use," Compensating Executive Worth, ed. by Russell F. Moore (New York: American Management Association, 1968).

that the tax advantages to qualified stock options reside only in those who have very large incomes. Crystal points out that on the above basis qualified stock options do not make sense from a cost-effective standpoint for any executives regardless of how much they are paid.[1]

The provisions of the qualified stock option requiring an exercise of options within five years of the date of grant and the first-in first-out rule have worked to the greatest disadvantage to the executive. The decline in stock market prices in 1969 and 1970 occurred at a time when many executives had to exercise their options or lose them. Coincident with the decline in the economy there was a rise in interest rates to combat inflation. Thereby, in addition, those who had exercised options earlier found themselves forced to sell them prior to the three year capital gains treatment holding period in order to protect the loans they had made to buy the stock.[2]

NON-QUALIFIED STOCK OPTIONS

Arch Patton defines a non-qualified option as any option which does not meet Bureau of Internal Revenue tax qualifications for capital gains treatment.[3] More specifically, non-qualified stock options are identified by the following characteristics.

1. They can be made effective for any number of years as compared to the five year limitation on qualified options.

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[1] Crystal, "The 10 Commandments of Executive Compensation," p. 54.

[2] Patton, "Are Stock Options Dead?" p. 23.

[3] <u>Ibid</u>., p. 29.

2. They can be offered at a price below the market price on the day they are granted.

3. They are tax deductible for the corporation as a salary expense at the time they are exercised by the recipient.

4. The recipient must pay tax at ordinary income rates on the appreciation gained between the date granted and the date exercised.

5. They do not have to be exercised in the sequence in which they were granted and you can exercise a non-qualified option even if you have a qualified option outstanding.

6. There is no three year holding period as is applicable to qualified stock options.[1]

Non-qualified options have been in existence for some time but they are becoming more popular now that the capital gains differential has all but disappeared. It is obvious from the above list of characteristics that they offer the executive more flexibility than do qualified options. Patton sees the increased flexibility as a detrimental characteristic from the view of the company in that they do not fill the entrepreneurial need.[2]

Some arguments offered in support of this opinion are that, since they are offered below the current market price, it is advantageous to the recipient to exercise them more quickly. Since profit is treated as current income, executives are being forced to sell some of them at the time of exercise in order to pay taxes. This is acting counterproductive to the objective of having executives buildup personal equity in the enterprise. Another objection is that any differential between market value and option price at the date the option is granted is paid to the

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[1]Louis, "Hidden Jokers in the New Tax Deck," p. 112.

[2]Patton, "Are Stock Options Dead?" p. 29.

individual by reducing the equity of public shareholders.[1] As in the case of qualified stock options the corporation realizes an opportunity loss on the difference in market price between the date of the grant and the date of exercise.

The non-qualified option is advantageous to the executive since he does not have to borrow money for an extended period of time since there is no minimum holding period. However, he does have to hold them for six months as does any stock purchaser to make any appreciation in value after the date of exercise eligible for capital gains treatment. However, if the company has a tendency to pressure its executives to hold stock, he will be little better off with a non-qualified option than he would have been with a qualified stock option. He will in essence be forced voluntarily to continue to borrow the funds required to finance the stock over a long period of time.[2]

PHANTOM STOCK

Phantom stock plans have been in use for a number of years but were previously used primarily as a deferred compensation device in conjunction with developing retirement income sources. Now companies have started to use the idea on a short term basis.[3] With phantom stock plans, the company credits an executive's account with a block of imaginary stock shares. The books

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[1] Ibid., p. 30.

[2] Crystal, Financial Motivation for Executives, p. 232.

[3] "Top Men Demand New Kinds of Pay," Business Week, January 23, 1971, p. 66.

are kept as if actual shares of stock had actually been set aside. When the company pays dividends, it will be assumed that the phantom share is generating dividends at that rate. In cases of stock splits and stock dividends comparable treatment exists.[1]

Under some plans the full value of the fictitious stocks is eventually distributed to the executive. Under others, only the amount of any gain in market value between the time the stock was credited to the account and the established distribution date is paid out. For example: Corporation A credits an executive with 500 shares currently selling on the market at $100. After a stipulated waiting period of 5 years in this hypothetical case, the market price of the stock has risen to $175. In addition, dividends have been received and reinvested into more shares of phantom stock during this period. The executive would then get the appreciation on each share originally granted ($75 x 500 or $37,500) and additional payment for the reinvested shares (10 x $175 or $1,750). His total compensation would be $39,250.[2] The company would obtain a tax deduction for $39,250 at the time of exercise.

He will have to pay the personal income tax rate of 50%, assuming his other income places him in this tax bracket. If the plan has been developed with a risk of forfeiture provision, the income will not be subject to additional taxes under extraordinary income provisions of the Tax Reform Act of 1969. The forfeiture requirement is usually met by a provision which causes

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[1]Louis, "Hidden Jokers in the New Tax Deck," p. 101.

[2]"Phantom Stock Is a Lure," Business Week, May 23, 1970, p. 111.

the executive to relinquish his ownership claim to the phantom stock if he leaves the company before the payoff date.[1]

From an individual executive's point of view, the tax aspects of phantom stock plans which contain significant deferral provisions are somewhat uncertain. Some tax men feel that, in addition to ordinary income taxes, gains may also be subject to a special tax as deferred income.[2]

Used in conjunction with company bonus plans, the phantom stock can serve as a means of conserving working capital for the firm as well as providing an additional relationship between the financial well being of the firm and the individual. In addition, it does not provide a threat to shareholders' equity. However, Arch Patton is quick to point out that it does not provide the entrepreneurial incentive value resident in qualified stock options in their better days.[3]

It can be seen that since no funds are required of the executive in order to take advantage of this form of compensation, it is attractive to executives at all levels within the corporation. However, too broad a use of this device can cause the cost of a company's compensation plan to increase drastically in a time of rapidly rising stock market prices. The market price increase may not be accompanied by a parallel increase in the financial fortunes of the firm.

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[1]Ibid.

[2]Patton, "Are Stock Options Dead?" p. 154.

[3]Ibid.

RESTRICTED STOCK

Grants and options of restricted stock should not be confused with restrictive stock options granted before the 1964 Revenue Act was passed. The earlier restricted stock options were the predecessor of the qualified stock option. They could be granted for a ten year period, at a price as low as 85 percent of the market value as of the time of the grant and could be sold by an executive six months after exercise and two years after the grant with capital gains treatment on any gains.[1]

The options and grants of restricted stock are characterized by restrictions on the resale of the stock for a number of years except back to the company at its original price. In addition, the executive is usually required to forfeit the stock if he leaves the company before the restriction period has lapsed. No tax was assessed on it until the restrictions had lapsed. At the time of sale the executive is taxed at ordinary income tax rates on the difference in value between the price he paid for it and the fair market value as of the date of the grant or option. When the stock was sold, the executive paid long-term capital gains taxes on any appreciation above the fair market value on the date of the grant.[2]

Restricted stock was the best of all worlds between 1967 and 1969. Used in an option, it gave the executive the capital gains tax treatment of a qualified stock option and the flexibility of

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[1]Harland Fox, Top Executive Compensation, New York: National Industrial Conference Board, Inc., 1966, p. 6.

[2]Crystal, "Financial Motivation for Executives," pp. 218-219.

option price and length of exercise period characteristic of a non-qualified option.[1]

The Tax Reform Act of 1969 gave this incentive particular attention. As a result the executive who receives restricted stock finds himself faced with a large decision. Within thirty days of the grant he has to decide whether to pay a tax at once, based on the market value at the time of this grant, or whether he will wait until restrictions lapse and pay a tax on the market value at that time. The problem is that, if he pays tax at the time of the grant, he gets no tax refund if the value of the stock has decreased at the time restrictions lapse. Another significant provision of the Tax Reform Act was that, if the executive chose to pay tax at the time restrictions lapsed, he would pay all tax at ordinary income rates based on the final market price.[1]

The corporation is eligible for a tax deduction under this type of option. It is essentially the same from a corporate point of view as the deferred stock bonus form of the phantom stock option. One minor difference is that the restricted stock, since it often must be sold back to the company, can be non-registered stock. However, the savings in not registering stock are relatively insignificant and company executives tend to bitterly resent this rather unsubtle device to force them to hold onto their option stock.[2]

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[1]Louis, "Hidden Jokers in the New Tax Deck," p. 111.

[2]Crystal, "Financial Motivation for Executives," p. 213.

TANDEM STOCK OPTIONS

Tandem stock options typically combine both qualified and non-qualified options. They are used in two ways. One form is for a company compensation committee to grant either qualified or non-qualified options as they consider appropriate. The other version is to grant the executive both kinds and let him choose which he will exercise up to a specified amount.[1]

For example, the executive could be granted a five-year qualified option and a ten-year non-qualified option. If the executive had not exercised either option during the first four years after the grant and the market conditions were unfavorable to exercise his qualified option before it expired, he would not lose his compensation but rather could exercise the non-qualified portion of this tandem in more favorable markets between the fifth and tenth years.[2]

David Kraus of the McKinsey and Company attributes much of the current popularity of the tandem plans to the fact that they provide "a hedge against still more tax law changes in the future."[3]

The current literature on executive compensation includes considerable discussion of the need to individualize executive compensation plans. The tandem plans in a small way accomplish this by giving the executive a limited choice in optimizing his personal needs in light of the conditions he is faced with in the tax and market environments.

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[1]"Top Men Demand New Kinds of Pay," p. 66.

[2]Patton, "Are Stock Options Dead?" p. 33.

[3]"Top Men Demand New Kinds of Pay," p. 66.

OVERALL CONSIDERATIONS

SIZE OF GRANTS

All the preceding discussion indicates stock options have been an important part of an executive's total compensation. The relative importance of grants is illustrated by a comparison of the size of the grants and the executive salary level.

Booz, Allen and Hamilton, Inc., conducted a survey of 450 executives in a variety of companies. From this survey, they developed a chart in which the stock option grants during a five year period were converted into multiples of base salaries. These five year multiples were then compared with annual base salary to graphically illustrate the relationship.[1] An adaptation of this presentation is included as Figure 3.

This chart illustrates that option grants increase as salaries increase in more than a straight line relationship. The size of the stock option is also shown to be quite large at the higher levels. For instance, based on the averaged data provided in the table, it would be expected that an executive receiving an annual salary of $100,000 a year would receive stock options of 7.0 x $100,000 or $700,000 value in a five year period. Of course the size of the grant does not automatically relate to the actual income received. However, it does illustrate that the more highly paid the executive the greater his opportunity for appreciation in income as a result of appreciation in the value of company stock.[2] In addition, it

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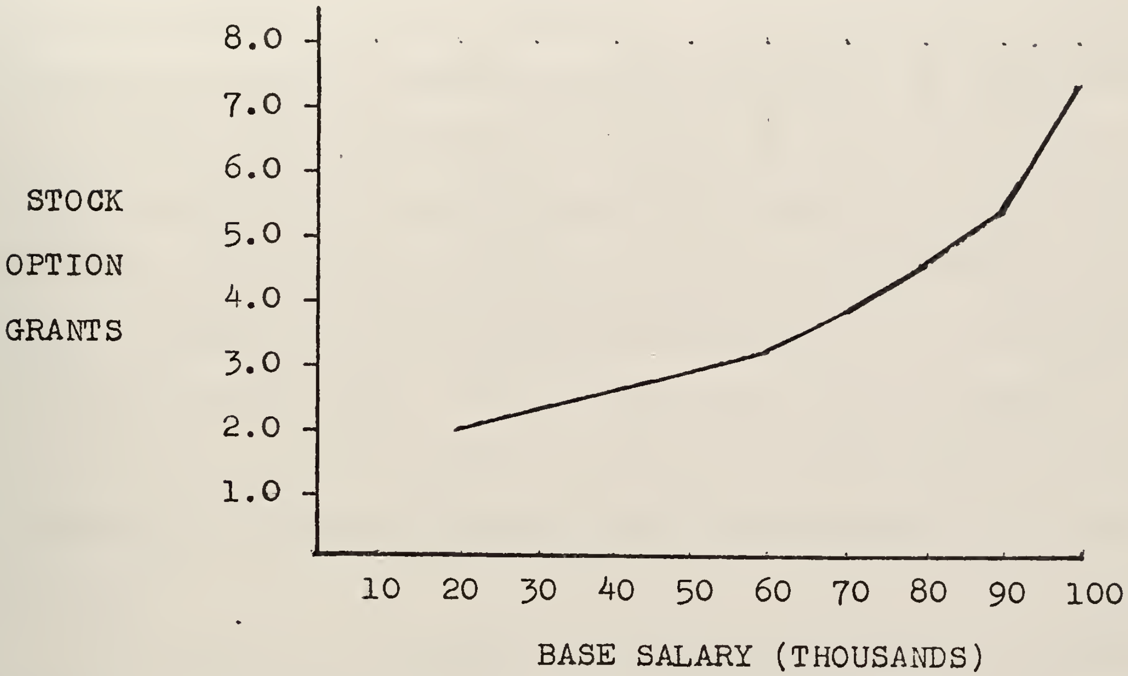
[1]Crystal, Financial Motivation for Executives, p. 206.

[2]Ibid., p. 207.

FIGURE 3

RELATIONSHIP OF STOCK OPTION GRANTS TO BASE SALARY



SOURCE: This figure is based on a similar chart constructed using a logarithmic scale by Graef S. Crystal in Financial Motivation for Executives, p. 206.

becomes obvious that granting stock options can have a significant effect on the distribution of equity ownership in a company.

COST OF STOCK OPTIONS AND VALUE OF REWARD

In previous discussions of stock options it has been pointed out that there are cost differentials among various alternative plans. In addition, the implication has been established that the value of the reward to an executive can vary among options as well as in the timing of receipt of payments.

These are realistic issues which must be analyzed and quantified in establishing and administering an executive compen-

sation program. Therefore, it is considered appropriate to provide an illustrative computation from the point of view of both the corporation and the executive. The computation illustrated is based on a similar computation made by George W. Hettenhouse.[1]

Assume the hypothetical executive is 55 years old. He is being offered a $1,000 phantom stock option which will be deferred for 10 years and paid as a lump sum at his retirement. Additionally, assume that upon retirement he would be in a 30 percent marginal tax bracket. If he dies before his retirement, the lump sum will go to his wife who will be in a 25 percent tax bracket. According to mortality tables, the probability of his surviving is .86.[2]

The after tax payment to the executive would be $1000 x .70 or $700 and for his survivor it would be $1000 x .75 or $750. The expected payout based on mortality rates is $700 x .86 + $750 x .14 or $707.

If the executive feels he has an after tax opportunity cost of 5 percent, the present value of this after tax payment is $\$707/(1.05)^{10}$ or $434.03.

From the company's point of view, assume the marginal tax rate is 48%. Thus, the after tax cost of the $1000 is $520. However, if the company can wait ten years to pay this money, it has the opportunity to use this money to realize an expected annual internal rate of return of 10 percent.[3] Therefore, the

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[1]Hettenhouse, "Cost/Benefit Analysis of Executive Compensation," pp. 117-118.

[2]Ibid.

[3]Brigham and Weston, Managerial Finance, p. 183.

cost of the plan to the company would be $\$520/(1.10)^{10}$ or \$200.46. Thus, reduced to a dollar basis, the cost to the firm is \$.46 for every dollar realized by the executive.

This technique can be used to compute various alternatives. The results of each of the computations can then be ranked in terms of relative costs to the firm and benefits to the executive. The final decision is likely to be made not only from this analytic base but also with due consideration for subjective factors.[1]

COMPANY SIZE AND GROWTH RELATED TO CAPITAL INCOME

In establishing an executive compensation plan in which stock options are intended to play a major part, a company can expect to have to be competitive if it is to attract and hold required executive talent. Therefore, it is considered significant to highlight what the results of a competitive stock option plan would be expected to yield to the top executives. Sibson and Company conducted a survey of the three top executives in 150 companies. They determined the paper profits made by these executives from 1965 through 1969. The results of these findings is the establishment of norms for capital income comparisons shown in Table 4.[2]

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[1]Crystal, "Financial Motivation for Executives," p. 227.

[2]Robert E. Sibson, "Executive Pay--A Time for Dramatic Change," Nations Business, November 1970, pp. 93, 96.

TABLE 4

GAINS FROM STOCK OPTIONS

EXECUTIVE'S AVERAGE ANNUAL SALARY + BONUS 1965 - 1969	CUMULATIVE FIVE YEAR GAINS COMPANY'S ANNUAL GROWTH RATE LOW	MEDIUM	HIGH
$ (000)	$(000)	$(000)	$(000)
250	380	490	730
230	350	460	695
210	315	430	660
190	280	400	630
170	250	370	595
150	215	340	560
130	180	305	530
110	145	275	495
90	110	240	460
70	80	210	425
50	45	180	395

NOTE: This study is based on options exercised by the top three executives in each of 150 companies. Low growth rate companies are those with an annual rate below 5 percent; medium, those with growth rates of 5 to 12 percent; high, those with growth rates above 12 percent.

SOURCE: Robert E. Sibson, "Executive Pay--A Time for Dramatic Change," Nations Business, November 1970, p. 96.

The study reveals that in small high growth companies, stock options are a significantly greater portion of income. Also, it appears to indicate that there is a correlation between the growth performance of a company and its policy with regard to the use of stock options.

Sibson points out that, companies tend to reach a size where a sustained growth of more than 12 percent annually becomes difficult to achieve.[1] One implication of this observation is that the role of stock options in an executive compensation program should be adjusted over time to remain in step with the entrepreneurial opportunity in the firm.

Perhaps the type of individual who will best meet the needs of the firm, as its chief executive, changes over time. This issue is dealt with in the next chapter as part of the consideration of the motivational aspects of executive compensation.

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[1] Ibid., p. 93

CHAPTER V

MOTIVATIONAL ASPECTS OF EXECUTIVE COMPENSATION

Up to this point the dominant theme of this study has been the identification of financial reward devices and the tax aspects of each. However, this emphasis provides an incomplete picture of an executive compensation plan. A firm does not exist to pay executives; the various means of paying an executive are perhaps less important than why the executive is retained and paid in a particular way. Crystal makes this point succinctly when he suggests one precept of an executive compensation plan should be "no taxation without motivation."[1]

A company, through the consciousness of its stockholders, retains the services of an executive in order to endow the organizational entity with the capability to satisfy certain expectations.[2] If stockholders have discernable objectives, it seems reasonable to assume that the efficiency of the company in meeting these objectives is more likely to be achieved when executive compensation plans are purposefully developed to encourage performance in desired directions.

In this chapter the works of behavioral scientists and management consultants sensitive to the motivational aspects of

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[1]Crystal, "The 10 Commandments of Executive Compensation," p. 53.

[2]Peter F. Drucker, "Management's New Role," Harvard Business Review, XLVII (November-December 1969) p. 50.

incentives will be drawn on to explore this subject from the point of view of both the firm and individual executive.

MOTIVATIONS OF THE OWNERS OF THE FIRM

The relationship of the owners of the business enterprise and its management would likely be defined differently if we were considering closely held family owned and operated firms, publicly held firms or cooperative business enterprises. For the purpose of the discussion the emphasis will be placed on the large publicly held firm.

In the publicly held enterprise the relationship between owners and managers is essentially financial. In considering the rationality of this relationship as it relates to corporate objectives the conceptualization illustrated in Figure 3 emerged in the mind of the author. This conceptual framework will serve as the focal point for considerations in this section of the paper.

The economic objective previously mentioned and the more broad perspective shown in Figure 3 are perhaps understood in terms of the following quotation.

> Ask any businessman, and almost any business student what the objectives of the firm are, and the answer is loud and clear: "profits." A second thought might add such related goals as "survival" and "growth," and a more thoughtful answer might even qualify this with the addition of..."through the creation of economic utility."[1]

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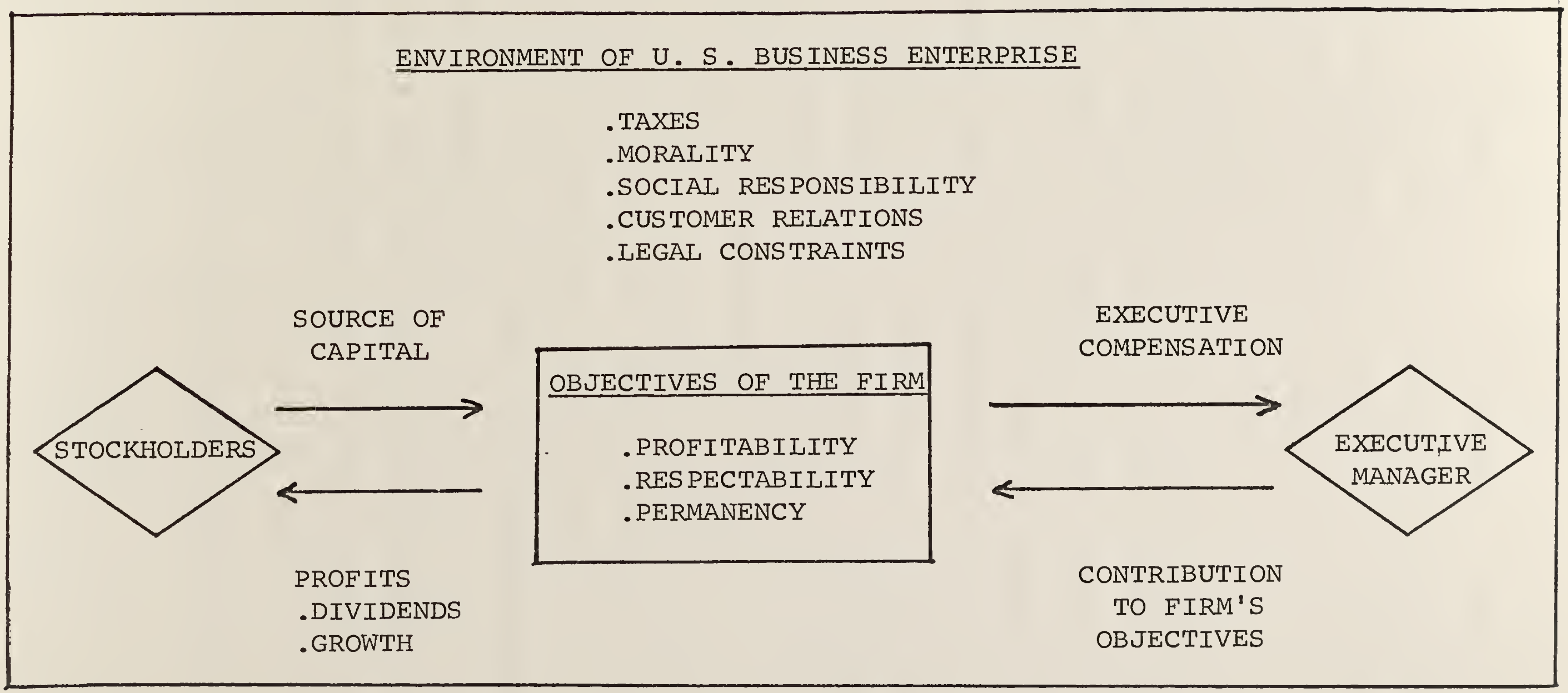
[1]Wilmar F. Bernthal, "Value Perspectives in Management Decisions," in Vol. II of Current Issues and Emerging Concepts in Management, ed. by Dalton E. McFarland (2 vols.; Boston: Houghton Mifflin Co., 1966) p. 446.

FIGURE 3

DETERMINISTIC ASPECTS OF OBJECTIVES OF THE FIRM



Profitability is a general term which can mean different things to different investors. It can mean the excess of returns over expenditures or the rate of return on invested capital.[1] This level of consideration is not sufficiently definitive to provide a formulation of corporate objectives on which an executive compensation plan can be built.

Individual investors entrust their funds to particular companies not only to obtain profits but also because they have preferences in the nature and timing of their rewards. An additional ingredient in an investor decision appears to be his concept of acceptable risk. An individual's acceptable level of risk is usually defined as that point where the pain from a dollar lost is equivalent to the pleasure of a dollar gained. This point usually increases in direct proportion to the amount of wealth possessed by an individual.[2]

An investor who makes an investment because he desires a constant level of dividends, would likely be attracted to a company such as American Telephone and Telegraph who has paid a dividend consistently since the 1920's and is characterized by a conservative price earnings ratio of 20 to 1 or less.[3] In contrast, an investor who is not adverse to risk and is more interested in growth potential than he is in a steady stream of dividends would be more likely to invest in stock of a company

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[1] Webster's New Collegiate Dictionary, Springfield, Mass.: G. & C. Merriam Co., 1953, p. 674.

[2] Brigham and Weston, Managerial Finance, pp. 224, 271.

[3] J. Keith Butters, ed., Case Problems in Finance (5th ed.; Homewood, Illinois: Richard D. Irwin, Inc., 1969), p. 234.

such as H. Ross Perot's Electronic Data Corporation. When the first offering of this stock was placed on the market in 1968, it sold at 118 times earnings and further appreciated in price 50 percent in the first week.[1]

The significant point is that, once a company establishes a reputation as a dividend payer or a growth company, it attracts a particular interest group of stockholders. When this relationship has become established the financial objectives of the firm have been established. The corporation then has assumed an obligation to conduct its business in such a way as to maximize the achievement of this objective.

In establishing an executive compensation plan, the firm should have this expectation in mind and design the plan to encourage growth, maintain a particular dividend payout, ensure a particular return on investment ratio or maintain a particular earnings per share ratio, as appropriate. Graef Crystal makes this point by stating that a plan should "incent only what you want to incent."[2]

When a stockholder invests in a firm he is doing so with the expectation that the company is a going concern. That is, he expects there is an obligation upon management to maintain the permanency of the firm by protecting its productive assets.[3]

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[1]"Perot's EDS: Entrepreneurial Archetype," MBA, Vol. VI, No. 3, December 1971, p. 45.

[2]Crystal, "The 10 Commandments of Executive Compensation," p. 56.

[3]Robert N. Antnony, Management Accounting, Text and Cases, (3rd ed.; Homewood, Illinois: Richard D. Irwin, Inc., 1964), p. 258.

This function of the chief executive can serve as a measure of his competency. In an instance where product market conditions are severely depressed, a manager who successfully minimized losses, perhaps to a greater degree than a competitor, is an appropriate subject for a reward since he is properly optimizing the long term interests of the firm.[1]

Peter Drucker has said that the responsibilities of management not only include administrative duties such as keeping the firm solvent and operating smoothly in a current environment. Management also has a responsibility to take action to ensure the long term growth of the firm through seeking and meeting entrepreneurial opportunities.[2]

In some firms these opportunities are greater and therefore should be given greater emphasis as objectives of the firm. This brings to mind another aspect of management responsibilities to stockholders. It has been pointed out by behaviorial scientists that there is in fact a life cycle phenomena which is observable in American business enterprises. Dr. Gordon Lippitt spoke of this in terms of a crucial conflict theory.[3]

This theory holds that a company follows a pattern of six stages in its development. Failure to meet each subsequent problem leads to decline. At each of these stages a critical

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[1]Crystal, "The 10 Commandments of Executive Compensation," p. 56.

[2]Drucker, "Management's New Role," p. 53.

[3]Gordon Lippitt, Professor of Behaviorial Sciences, The George Washington University. Lecture presented to students enrolled in course Management 207, Human Behavior in Organization on the subject of Behavioral Considerations in Organizational Change and Renewal," October 5, 1971.

issue is faced which requires a different emphasis from management. Table 5 is based on the author's concept of this theory as it relates to the requirements of management emphasis and changing growth potential.

TABLE 5

DEVELOPMENTAL CONCERNS OF A COMPANY

STAGE	CRITICAL CONCERN	PROBLEM FACING MANAGER	COMMENTS ON GROWTH POTENTIAL
1	Creation	Transform idea to reality	High risk--growth uncertain
2	Survival	Raise capital/ Refine products	Entrepreneurial attitude essential to growth
3	Stability	Develop efficient organization	Risk reduced--growth materialized
4	Pride and Reputation	Gain Respect in business community	Growth stabilizes
5	Uniqueness and adaptability	Optimize potential of organization	Efficiency a key word--growth more difficult
6	Contribution and creativity	Internal development of people and products for future	Future growth dependent on internally generated resources

Lippitt illustrated this concept's application to an American corporation when he said, "Henry Ford II did a good job in the 1950's and early 1960's in meeting the survival needs of his company. Now he should step down and put in a professional manager who will provide stability."[1]

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[1] Ibid.

This discussion brings to mind two significant characteristics which relate to stockholder and corporation objectives. First, to the extent the growth potential of firms change and the riskiness of business ventures change, a shift in the stockholder community may result. That is, the objectives of a firm are dictated by more than the stockholder desires. Second, the critical problems facing a firm change over time requiring different management emphasis to maintain the permanence of the firm.

In meeting these changing requirements, a shift in emphasis of an executive compensation plan to recruit and hold the desired talent would appear to be in order. Arch Patton, in referring to this aspect of executive compensation, said a particular company has "committed the cardinal recruiting sin of attracting men whose competitive characteristics did not happen to be compatible with the industry environment."[1]

An astute stockholder community in today's environment expects its management to maintain a reputation as a morally run business entity with concern for social responsibility and customer satisfaction. It is becoming recognized that "to the extent the firm is unwilling to further these higher goals, its own existence will be short lived."[2] The fact that social performance as well as financial return is in the vanguard of

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[1]Arch Patton, "What is an Executive Worth?" Management of Human Resources, ed. by Paul Pigors, Charles A. Myers and F. T. Malm, (New York: McGraw-Hill Book Co., 1964), p. 394.

[2]Bernthal, "Value Perspectives in Management Decisions," p. 447.

stockholder preference is accented by a new publication dedicated to corporate social responsibility which first appeared in January 1972 entitled, Business and Society Review.[1] One regular feature of this publication will guide stockholders to companies that emphasize social performance. Companies mentioned in the first issue as exemplary in this respect are Chase Manhattan Bank, Xerox, and Weyerhauser.[2]

It would then seem that an executive's reward should be influenced to some degree by the impact he has in leading his firm toward meeting a reasonable level of social performance. This subjective area gives some perspective to the "man for all seasons" nature of the executive's responsibilities to stockholders. Relating this to an executive compensation program is not easy. As Patton says, "the most difficult aspect of the top level executive job to judge is the contribution the incumbent makes to company policies that go beyond his functional responsibilities."[3]

MOTIVATIONS OF THE EXECUTIVE

What can be done to direct the energies of executives toward the achievement of those objectives which attract stockholders to the firm. The standard answer for years has been to give them money. Saul W. Gellerman says of this folklore concerning money:

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[1]"The Message Is 'Responsibility,'" Business Week, January 8, 1972, pp. 22-23.

[2]Ibid.

[3]Patton, "What Is an Executive Worth?" p. 393.

"Everyone knows why money affects the motivation of workers...money is supposed to be the main reason, if not the only one, that most people have for working at all. Knowing how to motivate is supposed to consist largely of knowing how to dangle money as artfully as possible before the eyes of one's subordinates."[1]

Even on the surface this seems to be an over simplification when one considers how different individuals are: how their financial situations differ; how their ages differ; how their family situations differ. It has also been observed that the individual executive's reaction to a particular means of compensation varies at different stages in a career.[2]

The time worn rhetorical question arises--"What makes Johnny run?" In recent years management has turned to behavioral scientists in an attempt to get the answer to this question.

In attempting to understand the motivations of top level executives, it was found that two particular behavioral science theories seem to provide a useful frame of reference. Abraham H. Maslow's "Hierarchy of Needs" theory explains what within the manager makes him succeptible to being motivated.[3] Frederick Herzberg's "Hygiene vs. Motivators" theory goes a long way toward giving clues as to what within a company's realm of practicality can be used as media of motivation.[4]

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[1]Saul W. Gellerman, "Motivating Men with Money," Fortune, LXXVII, No. 3 (March 1968), p. 144.

[2]Patton, Men, Money and Motivation, p. 35.

[3]Abraham H. Maslow, "The Study of Man at His Best...," Behavioral Science Concepts and Management Application, ed. by Harold M. F. Rush (New York: National Industrial Conference Board, Inc., 1969), p. 17.

[4]Frederick Herzberg, "One More Time: How Do You Motivate Employees?" Harvard Business Review, XLVI (January-February 1968), p. 57.

In applying motivation theory to an executive compensation program, it must be remembered that motivation is defined as the state of having an internal drive that incites the individual to some kind of action.[1] The problem facing management then is to sensitize the individual toward the desire for satisfaction of some basic needs and provide a set of conditions through which the sensitized needs can be accomplished. Table 6 illustrates the basic needs identified by Maslow, listed from most primitive to most sensitive.[2]

TABLE 6

MASLOW'S "HIERARCHY OF NEEDS"

NEED LEVELS	EXPLANATIONS
1. Physiological	Bodily requirements such as food, clothing and shelter
2. Safety	Physical and emotional security
3. Belongingness and Love	The need for other people
4. Esteem	Self respect and respect from others, worth, adequacy, competence
5. Self-Actualization	Know thyself--then being what one is capable of becoming

This theory holds that a higher need is not attainable until a minimum level of satisfaction is achieved in a lower level. The first four levels are considered "deficit" needs since their attainment is necessary for the achievement of maturity. In

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[1]Maslow, "The Study of Man at His Best...," p. 17.

[2]*Ibid.*

contrast, the fifth need--self-actualization--is a growth need. Its achievement is rare and attainable only by superior people. The best a company can do to encourage self-actualization is to provide an environment in which the superior individual can develop.[1] This is an environment in which an individual acquires an emotional identification with an objective or set of objectives which results in his imparting increased creative energy in his efforts.[2]

In his theory of "Hygiene vs. Motivators" Herzberg recognizes that factors which operate to provide job satisfaction and motivation are different than those providing job dissatisfaction. This distinction is quite comparable with Maslow's distinction between deficit needs and growth needs.[3]

He says that the opposite of job dissatisfaction is not satisfaction but rather no dissatisfaction. This description applies to the basic deficit needs of Maslow. Elements in the corporate bag of compensatory alternatives which are recognized as being of this essential hygiene nature are status, salary, security, and company policy.

Herzberg's counterpart to Maslow's growth needs are what are termed motivators. These operate in an employee's positive reaction to his job. He says the growth or motivator factors which are intrinsic to the job are achievement, recognition for

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[1]<u>Ibid</u>., p. 18-19.

[2]Patton, <u>Men, Money and Motivation</u>," p. 23.

[3]Herzberg, "One More Time: How Do You Motivate Employees?" pp. 56-57.

achievement, the work itself, responsibility, and growth or advancement.[1]

If money does not motivate, as was illustrated by the fact that Herzberg found salary not to be a motivator, then what is the role of money in an executive compensation program? This is a particularly poignant question above a level at which an executive has satisfied those basic needs which are dependent upon the exchange of money.

Saul W. Gellerman says that "satisfaction from money results primarily from an INCREASE in income, not from income itself."[2] The implication is that money used as a form of recognition causes it to become a motivator. However, in order forthis to be successful a few conditions have to be met--not the least of which is that the increment of increase has to be sufficient to make obvious the fact that an individual has been intentionally recognized. Another consideration is that with increased pay an executive usually acquires increased responsibilities. With these increased responsibilities an individual moves from a comfortable role in which he feels secure and self confident into a new situation which typically carries with it uncertainties, discomfort and anxieties. The more an individual has valued his previous situation, the more he will have to perceive the value of the reward to willingly accept the change.[3] The issue then is one of balancing the impact among the basic needs of the

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[1] Ibid.

[2] Gellerman, "Motivating Men with Money," p. 145.

[3] Ibid., p. 144.

individual. The threat to safety and social needs must be more than offset by the opportunity for esteem need satisfaction.

Money in the aggregated form known as wealth has been said to be a necessary ingredient to the credibility of an executive. A top executive is in a position to make unpopular and unwelcome decisions with acceptance by his contemporaries only if they acknowledge he is making the decision in the best interests of the company rather than in response to an ulterior motive. This idea is further accented by Gellerman when he said, "If there is any single quality that is required of a man at higher levels, it is credibility;...[1] This is the one acceptable answer the author has found for justifying the payment of $300,000 or more to an executive in a year.

The works of Herzberg and Maslow indicate that attention in an executive compensation plan should not only be focused on the almighty dollar. Attention should also be focused on status symbols, on the perceptions of individuals, on emphasizing the dignity and personal worth of individuals, and on providing security to the individual.

Individuals seem to seek recognition and a sense of importance in terms of the values and goals they share with others in groups. They perceive themselves as valued members of a group dignified in the eyes of their fellow members when they have been recognized as having been instrumental in attaining group goals.[2]

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[1]<u>Ibid</u>., pp. 180, 184.

[2]Rensis Likert, "Motivation: The Core of Management," <u>Management of Human Resources</u>, ed. by Paul Pigors, Charles A. Myers and F. T. Malm (New York: McGraw-Hill Co., 1964), p. 71.

These goals could be provided in the form of organization goals if a system of recognition can be developed by which the corporate goals are transformed into a form which is compatible with individual self interests. Graef Crystal suggests this is one of the commandments of instituting a bonus system. The recognition among group members is at least as important to the individual as the money.[1]

Compensation is not apt to motivate unless the individual can perceive that he can control his performance to the extent that he can be singled out as having been worthy of a reward.[2] This is one reason that some management writers emphasize the inapplicability of stock options as a broadly used device in corporate executive compensation programs. Crystal sums up this consideration by saying:

> Total responsibility for earnings per share,...is typically assigned to only two executives: the chairman and the president,...
>
> For other executives, the correlation between their performance and the market price of the company's stock is undoubtedly spurious and sometimes negative.[3]

In the literature of executive compensation there is much discussion of status and status symbols as cost effective compensatory media. A distinction should be made between the two. Status relates to real differences in amount of accountability, salary, and freedom of action. Status symbols refer to size of offices, titles, separate dining rooms, carpeting, and company

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[1]Crystal, "The 10 Commandments of Executive Compensation," p. 54.

[2]*Ibid*., p. 58.

[3]Crystal, *Financial Motivation for Executives*, p. 237.

cars. M. Scott Myers in describing a survey at Texas Instruments has made this comments about status symbols.

> Earned status is its own reward and the flaunting of symbols or other reminders of inequality is symptomatic of immaturity which serves only to undermine feelings of dignity and worth of those of lesser status,...[1]

Graef Crystal takes the opposite point of view with regard to the use of status symbols. He feels that no matter what companies do to avoid the use of status symbols they are inevitable. People naturally assign status to those paraphenalia which their bosses have and which they are denied whether it be a secretary, a rug, or a coffee pitcher. Status symbols are relatively inexpensive. It would be cheaper to buy an executive a $500 rug than give him a similar raise which would become an annual expenditure. In summing up his remarks on status symbols, Crystal said,

> I think that some companies are losing a bet when they don't use status symbols intelligently as a means of keeping their compensation package within tolerable means...[2]

Status symbols provide a sort of psychic income to the top executive and must be considered in the overall framework of an executive compensation plan. With the increased tax impact, the qualified stock option has become as much a status symbol as a means for financial reward.[3]

Security is becoming a matter of greater concern today than it was in earlier years. Robert Gordon cites the increase in

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[1]M. Scott Myers, "Conditions for Manager Motivation," Harvard Business Review, XLIV (January-February 1966), p. 67.

[2]Crystal, "The 10 Commandments of Executive Compensation," p. 62.

[3]Crystal, Financial Motivation for Executives, pp. 40-41.

pension and retirement plans for executives as indicative of this trend. He said:

> The significant point is not the nature of these pension plans but the indication that executives are laying increasing emphasis on security in their financial arrangements.[1]

This trend is cited as an indicator that within business today there is a movement toward hiring professional managers rather than hiring individuals who share the profit seeking motives of business leaders of an earlier day.[2] No evidence in the literature on executive compensation indicated that this is a commonly held concern. However, it does have implication in establishing an executive compensation plan.

The cumulative effects of deferred compensation, pensions, and retirement funds will cause the threat of the deficit needs of individuals to become more subdued when the executive begins to feel he has it made. If Maslow's theory is valid, then the emphasis in executive compensation programs for individuals so affected should be toward achieving self-actualization needs. It will be remembered that Maslow made a point of the fact that only superior individuals could achieve this level and these individuals are rare.[3]

However, the presence of motivation and the true self-actualizing individual are only two of three ingredients to the situation. These two will be wasted if the kind of organization

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[1]Robert Aaron Gordon, "Executive Compensation as an Incentive to Profitability," in Readings in Management, ed. by Ernest Dale (New York: McGraw-Hill Book Co., 1965), p. 297.

[2]Ibid.

[3]Maslow, "The Study of Man at His Best...," p. 19.

that can use them does not exist.

The motivators built into an executive compensation program must be compatible with the level of impact which an organization is willing to accept from a highly motivated individual.[1] The opportunity has to exist for changes in products, markets, size, or profitability.

Peter Drucker has made a prophetic statement regarding the impact of behavioral science theory on executive compensation programs.

> ...we will, within another 10 years, become far less concerned with management development (that is, adapting the individual to the demands of the organization); and far more with organization development (that is, adapting the company to the needs, aspirations, and potentials of individuals).[2]

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[1]Gellerman, "Motivating Men with Money," p. 184.

[2]Drucker, "Management's New Role," p. 52.

CHAPTER VI

TRENDS IN EXECUTIVE COMPENSATION

In previous chapters a broad understanding has been developed concerning the elements of an executive compensation plan. It has been shown that the environment in which such a plan is effected is subject to the continuous influence of change. Tax considerations are unstable, individual executive's needs differ and change over time and the disciplines of the behavioral scientists are having an impact.

Robert Saunders of Arthur D. Little, Inc. sees the present situation as a unique opportunity. He points out the receptivity which exists for change by stating:

> Today top management can make radical changes in its approach to compensating senior executives with the assurance that the need for innovative change will be recognized by all who will be affected by it as a natural part of our changing times. Such a favorable environment is somewhat a rarity.[1]

In this chapter information will be presented to illuminate the trends in executive compensation which are becoming evident as companies attempt to counteract the influences of change. The perspective is from the view of the total compensation plan. Therefore, in addition to stock options, the areas of bonus plans, individualization and professional financial planning will be considered.

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[1]Robert O. Saunders, Jr., "It's Cleanout Time for Executive Compensation," Business Management, Vol. 39, No. 6 (March 1971), p. 26.

INDIVIDUALIZED COMPENSATION

For years, companies have rewarded executives through plans which have been developed for application on a group basis. With increased recognition that behavioral science theories of motivation are valid and acknowledgement that the firm does have a paternal responsibility, this is changing. Now some firms are taking a different perspective. They determine what the individual executive needs and wants and attempt to custom tailor each executive's compensation package.[1]

Such programs involve working with the total income concept in terms of its cost to the company. In addition to cash based benefits, options can be offered such as time for travel and study, insurance programs, or variations in the timing of benefits based on the change in short term cash needs the executive experiences as his career progresses.[2]

There are two areas of resistance to the individualization of pay packages. These efforts are usually accompanied by increased cost and difficulty in administration. Also, top executives who grew up under the more structured plans tend to suffer from the myopia characterized by the cliche, "I've been through this myself and know what is best for my executives."[3]

A particularly noteworthy model for such a cafeteria approach has been offered by George Hettenhouse. He bases his

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[1]N. B. Winstanley, "Keeping Executive Compensation in Balance," Personnel, Vol. 42, No. 6 (March-April 1965), p. 31

[2]Crystal, "The 10 Commandments of Executive Compensation," pp. 62-64.

[3]Ibid.

proposal on the premise that to be practical, a plan must fulfill three objectives.

> 1. "It must be built on a common base level of compensation." That is, only executives with earnings in excess of a certain level, such as $50,000, would be eligible to participate in the plan. The assumption is that, below this level the demands on the executive's compensation to meet current expenses act to void any real advantages.
>
> 2. "The plan must be applied to a relatively small number of executives--those who already exercise some choice among a variety of payment packages." This rule is based on the fact that administrative costs are considerable.
>
> 3. "The plan must offer a reasonable number of attractive alternatives." The emphasis should not merely be on offering alternative payment streams of a particular compensation device but should also provide choices among a number of devices.[1]

Hettenhouse proposes to employ a computer oriented cost-benefit analysis of options based on the present value concept. The effect of various combinations of compensation devices in terms of the individual's tax bracket and financial situation are ranked by the use of computer simulation. The unalterable element in the computation is the total cost ceiling assigned by the company as the executive's level of compensation.[2]

Crystal feels that individualization of compensation plans through the use of a cafeteria approach greatly enhances the motivational value of compensation since it more directly caters to individual needs. He sees some need to discipline the approach to the extent that long term as well as short term objectives of the firm are given credence. However, he strongly opposes the attachment of the "golden handcuffs" approach to

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[1]George W. Hettenhouse, "Compensation Cafeteria for Top Executives," Harvard Business Review, XLIX (September-October, 1971), pp . 113-114.

[2]*Ibid.*, pp. 116-119.

this system. That is, if executives are going to choose deferral options, they must do so with assurance they will not have to forfeit such payments upon premature termination of employment with the firm.[1]

In conclusion, he predicts, "more and more companies will individualize more and more of their executive compensation package over the next ten years."[2]

The cafeteria approach to compensating top executives does not result in optimizing the financial situation of the executive unless it is based on sound financial planning.[3] Top executives are characteristically so busy they are unable to give their own financial needs adequate attention. Therefore, a new fringe genefit--executive financial planning--is gaining wide popularity.[4]

With many companies adopting such a fringe benefit, it can be expected that it will appear in many forms and be identified by different acronyms. One such effort called Plan FOUR (Financial Objectives Under Review) has been instituted by the United States Trust Company of New York. It will be described as illustrative of this fringe benefit.

Plan FOUR is applicable to certain top executives in the

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[1]Graef S. Crystal, "What's Ahead in Executive Compensation?" Compensating Executive Worth, ed. by Russell F. Moore, New York: American Management Association, 1968, pp. 31-32.

[2]*Ibid.*, p. 33.

[3]Hettenhouse, "Compensation Cafeteria for Top Executives," p. 115.

[4]Donald J. Petrie, "Executive Financial Planning--A New Fringe Benefit," Personnel, Vol. 48, No. 6 (November-December 1971), p. 17.

company. Under this program, the company hires an outside organization with expertise in law, taxes, insurance, and banking to develop and keep updated a particular executive's financial plan. The steps in this procedure are briefly outlined below.

a. The executive meets with his financial planner and divulges all aspects of his financial situation. In addition, he states his personal objectives and is evaluated in terms of his propensity for risk.

b. The financial planner, with the help of necessary experts does a thorough financial analysis of the executive's situation including a detailed analysis of each of his investments.

c. The financial planner will then develop a plan and present his suggestions to the executive for consideration.

d. A firm plan is then drawn up and the financial planner, as administrator, executes necessary financial transactions.

e. Periodically the plan is reviewed and updated. Each time the executive is given a compensatory choice by the company a decision is made with the benefit of the advice of the assigned financial planner.[1]

The approximate cost for each participating executive is $3,000 the first year and $1,000 each subsequent year. It is said that companies tend to use organization levels in deciding on eligibility. To be worth while, the executive must at least be in the $50,000 salary bracket.[2]

STOCK OPTIONS

Earlier in this paper, it was shown that stock options have been the prime entrepreneurial incentive in executive compensa-

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[1] Ibid., pp. 21-25.

[2] Ibid., p. 25.

tion programs. It was pointed out that their compensatory value was drastically affected by the Tax Reform Act of 1969 and the recession of 1969 and 1970. Yet the results of the 17th Annual Top Executive Compensation Survey conducted by McKinsey and Company indicates stock options are not showing a significant loss in popularity. A trend was noted in a slow change from qualified options toward non-qualified option plans.[1]

As was illustrated earlier in Figure 2, the Tandem stock option appears to be the most popular means of treading water while compensation experts attempt to find means of building the entrepreneurial incentive back into stock options. Two such ideas which appear promising in limited application are considered worthy of note.

In large stable corporations, the opportunity to employ the true entrepreneur is limited to new business ventures undertaken by the firm. In recognition of this fact some large corporations are instituting provisions in their executive compensation plans which provide an individual who successfully manages a new venture to be eligible for compensation above that customary at his level in the organization.[2]

The base salary of the individual is typically conservatively set but the opportunity for bonuses, non qualified stock options, or phantom stock options is greater. As a venture

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[1]George H. Foote, "Top Executive Pay Flattens Out," The McKinsey Quarterly, Vol. VIII, No. 2 (Fall 1971), p. 30.

[2]Frederick W. Cook, "How to Give Venture Managers 'A Piece of the Action,'" Business Management, Vol. 39, No. 6 (March 1971) p. 32.

manager, the individual usually assumes greater personal risk but can accrue a much greater pay-off.[1]

One such plan required the executive to make an initial investment of $10,000 in the venture which was set up as a separate business enterprise. The major financing was borrowed from the parent company as debt. If the venture proves successful the arrangement provides for making a public offering of the stock. Typically, the venture manager is given stock at a price to estimated earnings ratio of seven to one. Therefore, at the time of a public offering it would not be surprising to find the stock selling at an appreciated market price of 20 or more times earnings. The parent company will stand behind the venture company in its founding days thereby providing the professional management expertise and financial stability which will help make the stock an attractive public offering.[2]

Another innovative proposal involves the granting of restricted stock to top executives under the stipulation that this stock can be retained if distant quantifiable performance targets are met. For example, one company granted an executive $1 million dollars of restricted stock with a 25 year restriction period.[3]

In order to keep the full grant he was required to attain the following performance averages over a 10 year period: sales increase of 30 percent per year; increase in profits of 30 percent

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[1]Ibid., p. 38.

[2]Ibid., p. 32.

[3]Crystal, Financial Motivation for Executives, p. 241.

per year; and an annual return on invested capital of 35 percent. With such a program the executive is typically required to return some of the initial grant in accordance with an agreed upon schedule if he fails to meet the maximum objectives.[1]

Product expansion or new business ventures achieved through the formation of new subsidiary companies provide an opportunity to reward top executives by giving them preferential treatment by providing an opportunity to subscribe as initial shareholders in such public offerings. A recent example of this type transaction involving Kaiser Industries received wide publicity when disclosed.[2]

Kaiser had established a subsidiary in Canada entitled Kaiser Resources Limited to mine coal. As an "executive benefit" to 36 Kaiser executives, a plan was developed to purchase the stock through a specially set up holding company incorporated in Canada. The executives benefited from this transaction in two ways.

First, realizing the potential of the investment because of inside corporate information, the executives believed the price was a bargain, offering them an opportunity for a quick profit; and second, "by purchasing an original issue of Canadian stock, they could apply to the Canadian Internal Revenue Service for an exemption from the U. S. interest equalization tax, saving themselves $1.80 a share tax on top of the $12 offering price."[3]

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[1] Ibid.

[2] "All in the Family: How Top Officials at Kaiser Set Up a 'Fringe Benefit,'" Wall Street Journal, January 5, 1972, pp. 1, 13.

[3] Ibid., p. 13.

Such arrangements which are advantages to some degree because of the availability of inside information can raise moral issues in the minds of the public, as happened in the above cited case. Therefore, a very judicious evaluation in terms of the benefit to executives weighed against the damning effect of bad publicity has to be made. Obviously, it would be most difficult to show that each of the 36 executives made a professional contribution to the profitability of the subsidiary.

BONUS PLANS

In early discussions of bonus plans, it was noted that they tended to be tied to salary levels, they tended to reward short term performance, and they did not offer an entrepreneurial incentive. In order for bonus plans to fill some of the void in executive incentive lost through the regulatory restraints on stock option pay-out, some of these limitations in bonuses will have to be overcome. Crystal has offered such an innovative compensatory approach based on the bonus concept.[1]

The proposal recommends replacing the base salary with earnings-per-share equivalents as the means of allocating bonus payments to those executives with a significant impact on corporate decisions. The concept assumes the corporation establishes standards as to what is considered a desirable level of pre-tax earnings-per-share. Based on this figure, a total value of expected cumulative earnings-per-share for a specified

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[1]Graef S. Crystal, "Motivating for the Future: The Long Term Incentive Plan, "Financial Executive, Volume XXXIX, No. 10 (October 1971), pp. 50, 52.

number of years is computed. The executive is then paid a bonus in earnings-per-share equivalents on the amount he has caused earnings to exceed the desired level. He would be paid the actual earnings-per-share attained by the company on an established multiple of shares. If his efforts resulted in earnings to be double the target level, the number of hypothetical shares on which he received a bonus payment would be proportionately increased.[1]

This award could be made on an annual basis using the previous years during product development as a base for computing the standard and performance earnings-per-share measures. The number of years earnings is based on the number of years between the decision to market the product and its achieving profitability.

This proposal assumes that, due to the technologically intense nature of products the correctness of a business leader's decision is not evident for a number of years and it is often in the best interest of the firm to undertake investments with long development periods before a profit is realizable.[2]

TAX SHELTER INVESTMENTS

In an attempt to counteract the loss of capital gains tax advantages for qualified stock options, some companies are setting up tax sheltered investments such as apartment complexes in which they let top management participate.[3] The idea is that

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[1] Ibid.

[2] Ibid., p. 49.

[3] "Top Men Demand New Kinds of Pay," p. 65.

such executives who are in high tax brackets can create assets out of earning power that otherwise would be substantially reduced by tax payments. In addition, by becoming partners in such business ventures, the executives gain an additional advantage by claiming as tax deductions the expenses of operating the enterprise.[1] The long term appreciation from such investments result in adding to the executive's estate which can be liquidated at lower tax rates as a source of income during post retirement years.

McLaughlin of McKinsey and Company states that "smart companies,...continue to focus on performance and motivation rather than devise gimmicky plans that maximize tax advantages."[2]

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[1]Petrie, "Executive Financial Planning--A New Fringe Benefit," p. 23.

[2]"Top Men Demand New Kinds of Pay," p. 66.

CHAPTER VII

SUMMARY AND CONCLUSIONS

SUMMARY

An executive compensation plan has been shown to consist of three basic elements. These are base salary, supplemental compensation, and protective compensation. Base salary is the most generally accepted measure of the market value of an executive. Supplemental compensation is the ingredient by which the performance of the executive is tied to the performance of the business entity. Protective compensation is the catch all phrase for the various means by which an executive builds financial security for retirement years.

It has been shown that base salary levels can be correlated with the supply and demand relationships for a particular type of executive talent, the size of the business enterprise, and the potential impact of an executive's decisions on the fortunes of his company. Salary has customarily served as a significant determinant in the allocation of bonus awards and setting pension payment levels. Salaries are very seldom ever reduced. Therefore, there is a tendency to reward an executive for superior performance through the use of supplemental compensation rather than through an increase in salary which would harness a company to a large fixed charge in future years.

Salaries constitute a much higher percentage of total compensation for lower and middle management personnel than for those officers of the firm who are most instrumental in making vital decisions. However, since the salary of the top executive is the largest paid in the firm, it must be set at a level which will provide a realistic financial advancement path from first line management to top executive positions. Most large firms have formalized salary schedules in the form of a number of steps whose mid-points incrementally increase in dollar value in proportion to the average wage paid to similar positions in competitive companies within an industry.

Supplemental compensation has generally been paid in the form of cash bonuses and stock options. Bonus plans can be in any form from a strict percentage allocation of bonus funds available based on salary to an individualized reward for contribution to the firm based on accomplishment of established objectives. Bonus plans are not credited with being particularly motivational unless they can be individualized and unless the differentiation between the bonuses paid to competing contemporaries is sufficiently great to acknowledge superior performance.

The bonus is the most often used form of supplemental compensation for rewarding lower and middle management.

Bonuses are paid on a current basis as cash or portions of the bonus may be deferred for payment after retirement. In determining the advisability of deferring a bonus payment, an individual's current and estimated retirement tax bracket are

significant. If there is not much difference in these tax brackets, it is often found that the present value of the current cash bonus would be greater than a deferral plan.

If a deferral plan is used, it should not be encumbered with the "golden hand-cuffs" provisions. A truly worthwhile executive will be unlikely to be retained by a firm using a "golden hand-cuffs" rule since a hiring firm could offer sufficient compensating incentives to more than offset the loss of deferrals.

Stock options have been the primary entrepreneurial incentives offered by American business firms during the 1950's and 1960's. They provide a means by which executives acquire a financial interest in the firm. On this basis, it is postulated that the interests of the corporate executives are most likely to be brought into harmony with the interests of the majority of stockholders.

Stock options have been a major point of discussion in the literature on executive compensation in the 1960's and early 1970's. The center of attention is the effect major changes in tax laws in 1964 and 1969 have had on the value of stock options to executives. It has been shown that stock options have decreased in value to the executive as a means of receiving compensation due to an increase in capital gains tax rates and a parallel decrease in personal income tax rates.

The qualified stock option has been made non-cost-effective for nearly all executives due to these tax law changes. This situation has resulted in increased interest in such other forms

of stock options as restricted, phantom, non-qualified, and tandem options. These alternative forms of stock options are criticized in varying degrees because they tend to focus more on the short range objectives of the individual executive than the long range objectives of the firm's stockholders.

These alternative stock options are being implemented with varying forms of restrictions which tend to spread over a number of years the incremental cash flows on these options to executives.

Stock options are not dead. However, at this time their role as a truly effective incentive for the entrepreneur is questionable. In addition, it appears that stock options in the past were too broadly used. Only a limited number of executives occupy positions in the firm in which they can exercise influence on the long term decisions of the firm.

Today's environment, characterized by a business recession, an unstable tax situation, and wage and price controls imposed under President Nixon's economic recovery plan have left many corporations without a discernable course to follow in the reformulation of executive compensation plans. The tandem stock option plans appear to be gaining popularity as the interim form for preserving the entrepreneurial incentive in the long range context.

Much criticism has been leveled at executive compensation plans in the past on the basis that they showed an over emphasis on providing an after tax renumeration to the executive at the

expense of providing optimal motivation incentives toward achieving the objectives of the firm. Therefore, the current shake up in executive compensation plans is heralded by some as a rare opportunity to revise plans to more nearly meet both the needs of stockholders and executives.

The stockholders' connection with the firm is essentially financial. However, his expectations from the firm are not so simply stated. He makes his investment choice dependent upon the particular form of financial return such as dividends or large growth potential which are compatible with his needs and propensity for risk aversion. This symbiotic relationship between the reputation of the firm and the expectations of the stockholder tends to define the objectives of the firm. In addition, the image of the firm as a socially responsible member of the American business community is also an increasingly important determinant of corporate decisions.

The value of the theories of behavioral scientists in unraveling the motivations of executives is being recognized. A major impact of this movement is the trend toward greater individualization of executive compensation plans.

The individualization programs are generally based on a total compensation cost a firm is willing to pay for a particular executive. Within this cost limitation there is customarily a requirement that a portion of the cost be allocated to compensatory devices which provide entrepreneurial incentives and encourage achievement of long term corporate goals. The

individual executive can then choose any of a number of forms of compensation with current and deferred payment schedules which most nearly meet his needs. As an aid in making these decisions, many corporations are providing executives with computer simulation models and professional financial planning assistance.

There appears to be increasing recognition that an executive compensation plan should not only be sensitive to the individual executive but also that it must be tailored to the company. Every company is unique in terms of its size, stage of development, growth opportunities, competitive environment, product mix, and susceptibility to swings in the cycles of the economic community. Therefore, a well designed executive compensation program should be developed to encourage taking advantage of the peculiar opportunities available to the firm and minimizing the threat of the dangers it faces in its peculiar economic environment.

This fact dictates that a firm must spend time and effort to plan and develop a comprehensive executive compensation plan with the thoroughness with which it undertakes a new product development or a major capital expenditure. Executive talent is increasingly being recognized as a major element in the corporate inventory of capital assets. As with other capital assets, the executive with high performance potential should be allocated a complementary portion of corporate wealth. Likewise, those executives which have ceased to provide an acceptable return on the firm's other assets should receive lesser rewards or be replaced.

CONCLUSION OF THE STUDY

An executive compensation plan must be based on a total compensation concept if the company is to remain competitive in attracting, motivating, and keeping top caliber personnel; provide fair and rational treatment of its various executives; and control compensation costs and their relationship to the profitability of the firm. Such a program must be based on a soundly developed base-salary structure, must contain a number of fundamental compensation media for use by the firm and must provide considerable flexibility of application for both the firm and the individual.

The contents of the executive compensation plan for a particular firm cannot be prescribed from a list of general antedotes. The needs and environment of a firm and its executives are considered subject to sufficient variability to justify the development of a unique plan for each company. The variability of the form in which each of the major compensatory alternatives is employed should be determined based on an understanding of the peculiar needs of the firm, its stockholders, and the executives employed.

The following considerations should be given attention during the process of developing a comprehensive plan.

- An executive's compensation should be considered in totality as a comprehensive plan for renumeration and motivation.

. An executive compensation plan should be based on flexibility to provide for meeting the varying needs of the individual and the firm.

. A degree of entrepreneurial incentive should be built into the plan which is compatible with the opportunities available in the firm.

. A plan should include provisions for providing unusual compensatory opportunities for venture managers.

. A plan should not be built to accomodate particular tax environments thereby requiring major restructuring at short intervals.

. A plan should be kept fine-tuned over time to maintain its appeal and effective contribution to the changing objectives of the firm and the executive.

. The plan should include a provision for providing sufficient differentiation in monetary awards to ensure both superior and inferior performance are properly recognized.

. Non-monetary forms of compensation such as status symbols, personal counseling services, use of company recreation facilities or use of company vehicles should be included in a plan; since, when used discriminately, they have a high motivational value at a relatively low cost.

SUGGESTIONS FOR FURTHER STUDY

In concluding this study, it has become obvious that the measurement of top executive performance is an imprecise yet necessary ingredient for the administration of an effective executive compensation program. The literature in the field of executive compensation contains a number of dissertations on the application of various performance measurement techniques to allocating bonuses and stock options. However, the tying together of these approaches into a performance measurement system capable of meeting the needs of a comprehensive total compensation package does not seem to have been accomplished. A study in this area is considered necessary for the development of a means of administering an executive compensation program.

In the process of conducting this study, a significant number of references in the literature extolled the virtues of the entrepreneurial incentive. However, nowhere is there a discussion of the optimal mix of ownership identity, managerial ability, business experience, and business environment which is most likely to foster the attainment of the entrepreneurial objective. It is felt that a study in this area could result in a more cost-effective investment of company resources in executive compensation.

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